

# Internal Revenue bulletin

Bulletin No. 2004-20  
May 17, 2004

## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### INCOME TAX

**Rev. Rul. 2004-46, page 915.**

**Royalties; information reporting.** This ruling provides guidance concerning the reporting requirements of sections 6041 and 6050N of the Code for payments by publishers to literary agents on behalf of an author.

**T.D. 9121, page 903.**

**REG-139792-02, page 926.**

Final, temporary, and proposed regulations under section 704(b) of the Code provide guidance on the proper allocation of certain foreign tax expenditures of a partnership. A public hearing on the proposed regulations is scheduled for September 14, 2004.

**T.D. 9123, page 907.**

Final regulations under section 1296 of the Code provide procedures for certain U.S. persons holding marketable stock in a passive foreign investment company (PFIC) to elect mark to market treatment for that stock under section 1296 and related provisions of sections 1291 and 1295.

**T.D. 9124, page 901.**

Final regulations provide that all activities are subject to the rule under section 465 of the Code that amounts borrowed from a person who has an interest in an activity other than that of a creditor or from a person related to a person (other than the borrower) with such an interest do not increase the amount at risk in the activity.

**REG-116564-03, page 927.**

Proposed regulations under section 358 of the Code adopt a tracing approach in determining the basis of stock and securities received in transactions under sections 355, 368, and certain transactions that qualify under both section 351 and section 368.

**Rev. Proc. 2004-29, page 918.**

**Use of statistical sampling under section 274(n).** This procedure provides the statistical sampling methodology by which a taxpayer may establish the amount of meal and entertainment expenses excepted from the 50% deduction disallowance of section 274(n)(1) of the Code.

### EXEMPT ORGANIZATIONS

**Announcement 2004-36, page 932.**

A list is provided of organizations now classified as private foundations.

Finding Lists begin on page ii.



Department of the Treasury  
Internal Revenue Service

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 132.—Certain Fringe Benefits

26 CFR 1.132-6: *De minimis* fringes.

Procedures are provided by which taxpayers may use statistical sampling to determine the amount of expenses for meals excepted from the 50% deduction disallowance of section 274(n)(1) by reason of section 274(n)(2)(B) (relating to *de minimis* fringes). See Rev. Proc. 2004-29, page 918.

## Section 162.—Trade or Business Expenses

Procedures are provided by which taxpayers may use statistical sampling to determine the amount of trade or business expenses for meals and entertainment excepted from the 50% deduction disallowance of section 274(n)(1). See Rev. Proc. 2004-29, page 918.

## Section 274.—Disallowance of Certain Entertainment, etc., Expenses

Procedures are provided by which taxpayers may use statistical sampling to determine the amount of meal and entertainment expenses excepted from the 50% deduction disallowance of section 274(n)(1). See Rev. Proc. 2004-29, page 918.

## Section 465.—Deductions Limited to Amount at Risk

26 CFR 1.465-8: *General rules; interest other than that of a creditor.*

### T.D. 9124

#### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### At-Risk Limitations; Interest Other Than That of a Creditor

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: These regulations finalize the rules relating to the treatment, for purposes of the at-risk limitations, of amounts

borrowed from a person who has an interest in an activity other than that of a creditor or from a person related to a person (other than the borrower) with such an interest. These regulations affect taxpayers subject to the at-risk limitations and provide them with guidance necessary to comply with the law.

**DATES: Effective Date:** These regulations are effective May 3, 2004.

**Applicability Date:** For dates of applicability, see §§1.465-8(e) and 1.465-20(d).

**FOR FURTHER INFORMATION CONTACT:** Tara P. Volungis or Christopher L. Trump, 202-622-3070 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

This document contains amendments to 26 CFR part 1 to provide rules relating to the treatment, for purposes of the at-risk limitations under section 465 of the Internal Revenue Code (Code), of amounts borrowed from a person who has an interest in an activity other than that of a creditor. On June 5, 1979, the IRS published in the **Federal Register** (44 FR 32235) proposed regulations (LR-166-76) relating to the treatment of investments in certain activities under section 465 of the Code. On July 8, 2003, a notice of proposed rulemaking (REG-209377-89, 2003-36 I.R.B. 521 [68 FR 40583]) amending §§1.465-8 and 1.465-20 of the proposed regulations was published in the **Federal Register**. No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. The proposed regulations under §§1.465-8 and 1.465-20 are adopted by this Treasury decision.

##### Explanation of Provisions

Section 465 limits the deductibility of losses to a taxpayer's economic investment (the amount at risk) in the activity at the close of a taxable year. A taxpayer is

generally considered at risk in an activity to the extent of cash and the adjusted basis of property contributed by the taxpayer to the activity. In general, a taxpayer's amount at risk also includes any amounts borrowed for use in the activity if the taxpayer is personally liable for repayment or if property other than property used in the activity is pledged as security.

Under section 465(b)(3), amounts borrowed for use in an activity will not increase the borrower's amount at risk in the activity if the lender has an interest other than that of a creditor in the activity (a disqualifying interest) or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. Section 465(c)(3)(D) provides that this rule applies to new activities (activities that were not subject to section 465 before 1978) only to the extent provided in regulations.

These regulations apply the rule of section 465(b)(3) to new activities and provide rules for determining when a person has an interest in an activity other than that of a creditor. Additional rules are provided with respect to related persons, interests as a shareholder, and qualified nonrecourse financing.

##### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel

for Advocacy of the Small Business Administration for comment on their impact on small business.

### Drafting Information

The principal authors of these regulations are Tara P. Volungis and Christopher L. Trump of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Section 1.465–8 also issued under 26 U.S.C. 465.

Section 1.465–20 also issued under 26 U.S.C. 465. \* \* \*

Par. 2. Sections 1.465–8 and 1.465–20 are added to read as follows:

*§1.465–8 General rules; interest other than that of a creditor.*

(a) *In general*—(1) *Amounts borrowed*. This section applies to amounts borrowed for use in an activity described in section 465(c)(1) or (c)(3)(A). Amounts borrowed with respect to an activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor or is related to a person (other than the borrower) who has an interest in the activity other than that of a creditor. This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. For additional rules relating to the treatment of amounts borrowed from these persons, see §1.465–20.

(2) *Certain borrowed amounts excepted*. (i) For purposes of determining a corporation's amount at risk, an interest in the corporation as a shareholder is not an

interest in any activity of the corporation. Thus, amounts borrowed by a corporation from a shareholder may increase the corporation's amount at risk.

(ii) For purposes of determining a taxpayer's amount at risk in an activity of holding real property, paragraph (a)(1) of this section does not apply to financing that is secured by real property used in the activity and is either—

(A) Qualified nonrecourse financing described in section 465(b)(6)(B); or

(B) Financing that, if it were nonrecourse, would be financing described in section 465(b)(6)(B).

(b) *Loans for which the borrower is personally liable for repayment*—(1) *General rule*. If a borrower is personally liable for the repayment of a loan for use in an activity, a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

(2) *Capital interest*. For the purposes of this section, a capital interest in an activity means an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity. The partners of a partnership and the shareholders of an S corporation are considered to have capital interests in the activities conducted by the partnership or S corporation.

(3) *Interest in net profits*. For the purposes of this section, it is not necessary for a person to have any incidents of ownership in the activity in order to have an interest in the net profits of the activity. For example, an employee or independent contractor any part of whose compensation is determined with reference to the net profits of the activity will be considered to have an interest in the net profits of the activity.

(4) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

*Example 1*. A, the owner of a herd of cattle sells the herd to partnership BCD. BCD pays A \$10,000 in cash and executes a note for \$30,000 payable to A. The three partners, B, C, and D, each assumes personal liability for repayment of the amount owed A. In addition, BCD enters into an agreement with A under which A is to take care of the cattle for BCD in return for compensation equal to 6 percent of BCD's net profits from the activity. Because A has an interest in the net profits of BCD's farming activity, A is considered to have an interest in the activity other than that of a creditor. Accordingly, amounts payable

to A for use in that activity do not increase the partners' amount at risk even though the partners assume personal liability for repayment.

*Example 2*. Assume the same facts as in *Example 1* except that instead of receiving compensation equal to 6 percent of BCD's net profits from the activity, A instead receives compensation equal to 1 percent of the gross receipts from the activity. A does not have a capital interest in BCD. A's interest in the gross receipts is not considered an interest in the net profits. Because B, C, and D assumed personal liability for the amounts payable to A, and A has neither a capital interest nor an interest in the net profits of the activity, A is not considered to have an interest in the activity other than that of a creditor with respect to the \$30,000 loan. Accordingly, B, C, and D are at risk for their share of the loan if the other provisions of section 465 are met.

*Example 3*. Assume the same facts as in *Example 1* except that instead of receiving compensation equal to 6 percent of BCD's net profits from the activity, A instead receives compensation equal to 6 percent of the net profits from the activity or \$15,000, whichever is greater. A is considered to have an interest in the net profits from the activity and accordingly will be treated as a person with an interest in the activity other than that of a creditor.

(c) *Nonrecourse loans secured by assets with a readily ascertainable fair market value*—(1) *General rule*. This paragraph shall apply in the case of a nonrecourse loan for use in an activity where the loan is secured by property which has a readily ascertainable fair market value. In the case of such a loan, a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

(2) *Example*. The provisions of this paragraph (c) may be illustrated by the following example:

*Example*. X is an investor in an activity described in section 465(c)(1). In order to raise money for the investment, X borrows money from A, the promoter (the person who brought X together with other taxpayers for the purpose of investing in the activity). The loan is secured by stock unrelated to the activity which is listed on a national securities exchange. X's stock has a readily ascertainable fair market value. A does not have a capital interest in the activity or an interest in its net profits. Accordingly, with respect to the loan secured by X's stock, A does not have an interest in the activity other than that of a creditor.

(d) *Nonrecourse loans secured by assets without a readily ascertainable fair market value*—(1) *General rule*. This paragraph shall apply in the case of a nonrecourse loan for use in an activity where the loan is secured by property which does not have a readily ascertainable fair market value. In the case of such a loan, a person shall be considered a person with

an interest in the activity other than that of a creditor if the person stands to receive financial gain (other than interest) from the activity or from the sale of interests in the activity. For the purposes of this section, persons who stand to receive financial gain from the activity include persons who receive compensation for services rendered in connection with the organization or operation of the activity or for the sale of interests in the activity. Such a person will generally include the promoter of the activity who organizes the activity or solicits potential investors in the activity.

(2) *Example.* The provisions of this paragraph (d) may be illustrated by the following example:

*Example.* A is the promoter of an activity described in section 465(c)(1). As the promoter, A organizes the activity and solicits potential investors. For these services, A is paid a flat fee of \$130x. This fee is paid out of the amounts contributed by the investors to the activity. X, one of the investors in the activity, borrows money from A for use in the activity. X is not personally liable for repayment to A of the amount borrowed. As security for the loan, X pledges an asset which does not have a readily ascertainable fair market value. A is considered a person with an interest in the activity other than that of a creditor with respect to this loan because the asset pledged as security does not have a readily ascertainable fair market value, X is not personally liable for repayment of the loan, and A received financial gain from the activity. Accordingly, X's amount at risk in the activity is not increased despite the fact that property was pledged as security.

(e) *Effective date.* This section applies to amounts borrowed after May 3, 2004.

#### *§1.465-20 Treatment of amounts borrowed from certain persons and amounts protected against loss.*

(a) *General rule.* The following amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged—

(1) Amounts that do not increase the taxpayer's amount at risk because they are borrowed from a person who has an interest in the activity other than that of a creditor or from a person who is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor; and

(2) Amounts (whether or not borrowed) that are protected against loss.

(b) *Interest other than that of a creditor; cross reference.* See §1.465-8 for addi-

tional rules relating to amounts borrowed from a person who has an interest in the activity other than that of a creditor or is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor.

(c) *Amounts protected against loss; cross reference.* See §1.465-6 for rules relating to amounts protected against loss.

(d) *Effective date.* This section applies to amounts borrowed after May 3, 2004.

Mark E. Matthews,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved April 26, 2004.

Gregory F. Jenner,  
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on April 30, 2004, 8:45 a.m., and published in the issue of the Federal Register for May 3, 2004, 69 F.R. 24078)

## **Section 704.—Partner's Distributive Share**

*26 CFR 1.704-1: Partner's distributive share.*

### **T.D. 9121**

#### **DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1**

#### **Partner's Distributive Share: Foreign Tax Expenditures**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: The temporary regulations provide rules for the proper allocation of partnership expenditures for foreign taxes. The temporary regulations affect partnerships and their partners. The text of the temporary regulations also serves as the text of the proposed regulations (REG-139792-02) set forth in this issue of the Bulletin. The final regulations consist of technical revisions to reflect the issuance of the temporary regulations.

DATES: *Effective Date:* These regulations are effective April 21, 2004.

*Applicability Date:* For dates of applicability, see §1.704-1(b)(1)(ii).

FOR FURTHER INFORMATION CONTACT: Beverly Katz at 202-622-3050 (not a toll-free number).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

Subchapter K is intended to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring an entity-level tax. To achieve this goal of a flexible economic arrangement, partners are generally permitted to decide among themselves how a partnership's items will be allocated. Section 704(a) of the Internal Revenue Code (Code) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided, be determined by the partnership agreement.

Section 704(b) places a significant limitation on the general flexibility of section 704(a). Specifically, section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect. Thus, the statute provides that partnership allocations either must have substantial economic effect or must be in accordance with the partners' interests in the partnership.

Section 1.704-1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss, or deduction to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect within the meaning of §1.704-1(b)(2)(ii). Second, the economic effect of the allocation must be substantial within the meaning of §1.704-1(b)(2)(iii).

For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that, in the event that

there is an economic benefit or burden that corresponds to the allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden. §1.704-1(b)(2)(ii). Generally, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides: (1) for the determination and maintenance of the partners' capital accounts in accordance with §1.704-1(b)(2)(iv); (2) for liquidating distributions to the partners to be made in accordance with the positive capital account balances of the partners; and (3) for each partner to be unconditionally obligated to restore the deficit balance in the partner's capital account following the liquidation of the partner's partnership interest. In lieu of satisfying the third criterion, the partnership may satisfy the qualified income offset rules set forth in §1.704-1(b)(2)(ii)(d).

Section 1.704-1(b)(2)(iii)(a) provides as a general rule that the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. The section further provides that, even if the allocation affects substantially the dollar amounts, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

The regulations under section 704(b) provide that the allocation of certain items cannot have substantial economic effect, and accordingly provide guidance on allocating those items in a manner that will be deemed to be in accordance with the partners' interests in the partnership. Items that cannot be allocated with substan-

tial economic effect include tax credits, nonrecourse deductions, and recapture amounts. These items are addressed in §§1.704-1(b)(4) and 1.704-2.

## Explanation of Provisions

### 1. *Clarifying the Allocation of Expenditures for Foreign Taxes*

Section 901(b)(5) provides that an individual who is a partner will, subject to certain limitations, qualify for the foreign tax credit for his proportionate share of taxes of the partnership paid or accrued during the taxable year to a foreign country or to any possession of the United States. Section 702(a)(6) provides that each partner shall take into account separately his distributive share of the partnership's taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States. Section 703(a)(2)(B) provides that the partnership is not entitled to the deduction for taxes provided in section 164(a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States. Section 703(b)(3) provides that elections affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under section 901 (relating to taxes of foreign countries and possessions of the United States), will be made by each partner separately.

These temporary regulations clarify the application of the regulations under section 704 to creditable foreign tax expenditures for which the partnership bears legal liability as described in §1.901-2(f). Unlike most other trade or business expenses, foreign taxes described in section 901 or 903 are fully creditable against a partner's U.S. tax liability, subject to certain limitations, including primarily the foreign tax credit limitation under section 904. For this reason, the temporary regulations provide that partnership allocations of creditable foreign tax expenditures cannot have substantial economic effect and, therefore, must be allocated in accordance with the partners' interests in the partnership. A creditable foreign tax is a foreign tax paid or accrued for U.S. tax purposes by a partnership and that is eligible for a credit under section 901(a). A foreign tax is a creditable foreign tax for these purposes with-

out regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such amount.

The temporary regulations establish a safe harbor under which partnership allocations of foreign tax expenditures will be deemed to be in accordance with the partners' interests in the partnership. Under this safe harbor, if the partnership agreement satisfies the requirements of §1.704-1(b)(2)(ii)(b) or (d) (i.e., capital account maintenance, liquidation according to capital accounts, and either deficit restoration obligations or qualified income offsets), then an allocation of a foreign tax expenditure that is proportionate to a partner's distributive share of the partnership income to which such taxes relate (including income allocated pursuant to section 704(c)) will be deemed to be in accordance with the partners' interests in the partnership. This rule is consistent with the underlying purposes of the foreign tax credit, which is to avoid double taxation of foreign source income, and the foreign tax credit limitation, which is to prevent foreign tax credits from offsetting tax liability on a taxpayer's U.S. source income. Also, this rule achieves greater parity between entities that are taxed under foreign law at the partner level and entities that are taxed under foreign law at the entity level. If a partnership were taxed under foreign law at the partner level, then the amount of foreign taxes imposed on a partner generally would be proportionate to the partner's share of the income subject to the foreign tax. The partner would take into account this amount of foreign tax in computing U.S. tax liability. Likewise, for partnerships that are taxed under foreign law at the entity level, the safe harbor provides that a partner is allowed to take into account in computing U.S. tax liability the share of the partnership's foreign tax expenditures that is proportionate to the partner's share of the income to which such taxes relate.

If the taxpayer does not satisfy this safe harbor, then the taxpayer's allocations will be tested under the partners' interests in the partnership standard set forth in §1.704-1(b)(3). Under that standard, the determination of a partner's interest in a partnership is made by taking into account all facts and circumstances relating to the economic arrangement of the partners. Among the facts to be considered are:

(a) the partners' relative contributions to the partnership; (b) the interests of the partners in economic profits and losses (if different than their interests in taxable income or loss); (c) the interests of the partners in cash flow and other non-liquidating distributions; and (d) the rights of the partners to distributions of capital upon liquidation. Ultimately, the partners' interests in the partnership signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. The sharing arrangement with respect to a particular item may or may not correspond to the overall economic arrangement of the partners. Thus, a partnership's allocation of a foreign tax expenditure that does not satisfy the safe harbor contained in these temporary regulations, may, in unusual circumstances (such as where there is substantial certainty that U.S. partners will deduct, rather than credit, foreign taxes) be in accordance with partners' interests in the partnership under §1.704-1(b)(3).

## 2. Application of §1.704-1(b)(2)(iii) Substantiality Requirement Where Partnership Allocation Has Tax Effect on Owners of Partners

As discussed above, in determining if the economic effect of a partnership allocation is substantial, the partnership must consider the after-tax economic consequences to the partners. The IRS and Treasury have become aware that some partnerships are taking the position that, in determining if the economic effect of a partnership allocation is substantial, they need not consider any tax consequences to an owner of the partner that result from the allocation. The IRS and Treasury believe that such a position is inconsistent with the policies underlying the substantial economic effect rules, because it would allow a partnership to make tax-advantaged allocations if the tax advantages of the

allocations were to accrue to an owner of a partner, rather than to the partner itself. The IRS and Treasury are planning to issue guidance on the application of the section 704(b) regulations to these situations.

## 3. Effective Date

The provisions of these regulations generally apply for partnership taxable years beginning on or after the date that the temporary regulations are published in the Federal Register. A transition rule is also provided for existing partnerships. Under the transition rule, if a partnership agreement was entered into before April 21, 2004, then the partnership may apply the provisions of §1.704-1(b), as if the amendments made by this temporary regulation had not occurred, until any subsequent material modification to the partnership agreement, which includes any change in ownership, occurs. This transition rule does not apply if, as of April 20, 2004, persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party. No inference regarding the treatment of allocations of foreign taxes under §1.704-1(b) (prior to the amendments made by this temporary regulation) is intended.

## Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the notice of proposed rulemaking on this subject published in this issue of the Bulletin. Pursuant to section 7805(f) of

the Code, this notice of rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Drafting Information

The principal author of this regulation is Beverly M. Katz, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in its development.

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## Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.704-1 is amended as follows:

1. Paragraph (b)(0) is amended by adding entries for §§1.704-1(b)(1)(ii)(a), 1.704-1(b)(1)(ii)(b), 1.704-1(b)(4)(viii), 1.704-1(b)(4)(ix), 1.704-1(b)(4)(x), and 1.704-1(b)(4)(xi).

2. The text of paragraph (b)(1)(ii) is redesignated as paragraph (b)(1)(ii)(a).

3. A heading is added to newly designated paragraph (b)(1)(ii)(a).

4. Paragraphs (b)(1)(ii)(b), (b)(4)(viii), (b)(4)(ix), (b)(4)(x), and (b)(4)(xi) are added.

5. Paragraph (b)(5) is amended by adding *Example 20* through *Example 28*.

6. The additions read as follows:

*§1.704-1 Partner's distributive share.*

\* \* \* \* \*

*(b) Determination of partner's distributive share—(0) Cross-references.*

\* \* \* \* \*

Generally.....	1.704-1(b)(1)(ii)(a)
Foreign tax expenditures .....	1.704-1(b)(1)(ii)(b)
* * * * *	
[Reserved].....	1.704-1(b)(4)(viii)
[Reserved].....	1.704-1(b)(4)(ix)
[Reserved].....	1.704-1(b)(4)(x)
Allocation of creditable foreign taxes .....	1.704-1(b)(4)(xi)

\* \* \* \* \*

(1) \* \* \*

(ii) \* \* \*(a) *Generally*.

(b) *Foreign tax expenditures*. [Reserved]. For further guidance, see §1.704-1T(b)(1)(ii)(b).

\* \* \* \* \*

(4) \* \* \*

(viii) [Reserved].

(ix) [Reserved].

(x) [Reserved].

(xi) *Allocation of creditable foreign taxes*. [Reserved]. For further guidance, see §1.704-1T(b)(4)(xi).

(5) \* \* \* \* \*

Examples (20) through (24). [Reserved].

Examples (25) through (28). [Reserved]. For further guidance, see §1.704-1T(b)(5), Examples (25) through (28).

Par. 3. Section 1.704-1T is added to read as follows:

*§1.704-1T Partner's distributive share (temporary).*

(a) through (b)(1)(ii)(a) [Reserved]. For further guidance, see §1.704-1(a) through (b)(1)(ii)(a).

(b)(1)(ii)(b) *Rules relating to foreign tax expenditures—(I) In general*. The provisions of paragraphs (b)(4)(xi) (regarding the allocation of foreign tax expenditures) apply for partnership taxable years beginning on or after April 21, 2004.

(2) *Transition rule*. If a partnership agreement was entered into before April 21, 2004, then the partnership may apply the provisions of this paragraph (b) as if the amendments made by this temporary regulation had not occurred, until any subsequent material modification to the partnership agreement, which includes any change in ownership, occurs. This transition rule does not apply if, as of April 20, 2004, persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have

the power to amend the partnership agreement without the consent of any unrelated party.

(b)(1)(iii) through (b)(4)(vii) [Reserved]. For further guidance, see §1.704-1(b)(1)(iii) through (b)(4)(vii).

(b)(4)(viii) through (b)(4)(x) [Reserved].

(b)(4)(xi) *Allocations of creditable foreign taxes—(a) In general*. Allocations of creditable foreign taxes cannot have substantial economic effect and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. An allocation of a creditable foreign tax will be deemed to be in accordance with the partners' interests in the partnership if—

(1) The requirements of either paragraph (b)(2)(ii)(b) or (b)(2)(ii)(d) of this section are satisfied (*i.e.*, capital accounts are maintained in accordance with paragraph (b)(2)(iv) of this section, liquidating distributions are required to be made in accordance with positive capital account balances, and each partner either has an unconditional deficit restoration obligation or agrees to a qualified income offset); and

(2) The partnership agreement provides for the allocation of the creditable foreign tax in proportion to the partners' distributive shares of income (including income allocated pursuant to section 704(c)) to which the creditable foreign tax relates.

(b) *Creditable foreign taxes*. A creditable foreign tax is a foreign tax paid or accrued for U.S. tax purposes by a partnership and that is eligible for a credit under section 901(a). A foreign tax is a creditable foreign tax for these purposes without regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such amount.

(c) *Income related to foreign taxes*. A foreign tax is related to income if the income is included in the base upon which the taxes are imposed, which determination must be made in accordance with the

principles of §1.904-6. See *Examples* (25) through (28) of paragraph (b)(5) of this section.

(b)(5)\*\*\*

*Examples* 1 through 19 [Reserved]. For further guidance, see §1.704-1(b)(5), *Examples* 1 through 19.

*Examples* 20 through 24 [Reserved].

*Example* 25. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB's partnership agreement (within the meaning of paragraph (b)(2)(ii)(j) of this section) provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership. AB operates business M and earns income from passive investments in country X. Assume that country X imposes a 40 percent tax on business M income, which tax is a creditable foreign tax, but exempts from tax income from passive investments. In year 1, AB earns \$100 of income from business M and \$30 from passive investments and pays or accrues \$40 of country X taxes. For purposes of section 904(d), the income from business M is general limitation income and the income from the passive investments is passive income. Pursuant to the partnership agreement, all partnership items, including creditable foreign taxes, from business M are allocated 60 percent to A and 40 percent to B, and all partnership items, including creditable foreign taxes, from passive investments are allocated 80 percent to A and 20 percent to B. Accordingly, A is allocated 60 percent of the business M income (\$60) and 60 percent of the country X taxes (\$24), and B is allocated 40 percent of the business M income (\$40) and 40 percent of the country X taxes (\$16).

(ii) Under paragraph (b)(4)(xi) of this section, the \$40 of taxes is related to the \$100 of general limitation income and no portion of the taxes is related to the passive income. Because AB's partnership agreement allocates the general limitation income 60/40 and the country X taxes 60/40, the allocations of the country X taxes are in proportion to the allocation of the income to which the foreign tax relates. Because AB satisfies the requirement of paragraph (b)(4)(xi) of this section, the allocations of the country X taxes are deemed to be in accordance with the partners' interests in the partnership.

*Example* 26. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB's partnership agreement (within the meaning paragraph (b)(2)(ii)(j) of this section) provides that the partners'



capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership. AB operates business M in country X and business N in country Y. Assume that country X imposes a 40 percent tax on business M income, country Y imposes a 20 percent tax on business N income, and the country X and country Y taxes are creditable foreign taxes. In year 1, AB has \$100 of income from business M and \$50 of income from business N. Country X imposes \$40 of tax on the income from business M and country Y imposes \$10 of tax on the income of business N. Pursuant to the partnership agreement, all partnership items, including creditable foreign taxes, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including creditable foreign taxes, from business N are split evenly between A and B (50/50). Accordingly, A is allocated 75 percent of the income from business M (\$75), 75 percent of the country X taxes (\$30), 50 percent of the income from business N (\$25), and 50 percent of the country Y taxes (\$5). B is allocated 25 percent of the income from business M (\$25), 25 percent of the country X taxes (\$10), 50 percent of the income from business N (\$25), and 50 percent of the country Y taxes (\$5).

(ii) Because the income from business M and business N is general limitation income and the partnership agreement provides for different allocations with respect to such income, it is necessary to determine which foreign taxes are related to the business M income and which foreign taxes are related to the business N income. Under paragraph (b)(4)(xi) of this section, the \$40 of country X taxes is related to business M and the \$10 of country Y taxes is related to business N. Because AB's partnership agreement allocates the \$40 of country X taxes in the same proportion as the general limitation income from business M, and the \$10 of country Y taxes in the same proportion as the general limitation income from business N, the allocations of the country X taxes and the country Y taxes are in proportion to the allocation of the income to which the foreign taxes relate. Because AB satisfies the requirements of paragraph (b)(4)(xi), the allocations of the country X and country Y taxes are deemed to be in accordance with the partners' interests in the partnership.

*Example 27.* (i) The facts are the same as in *Example 26*, except that AB does not actually receive the \$50 accrued with respect to business N until year 2. Also assume that A, B and AB each report taxable income on an accrual basis for U.S. tax purposes and AB reports taxable income on a cash basis for country X and country Y purposes. In year 1, AB pays country X taxes of \$40. In year 2, AB pays country Y taxes of \$10. Pursuant to the partnership agreement, in year 1, A is allocated 75 percent of business M income (\$75) and country X taxes (\$30) and 50 percent of business N income (\$25). B is allocated 25 percent of business M income (\$25) and country X taxes (\$10) and 50 percent of business N income (\$25). In year 2, A and B will each be allocated 50 percent of the country Y taxes (\$5).

(ii) Because the income from business M and business N is general limitation income and the partnership agreement provides for different allocations

with respect to such income, it is necessary to determine which foreign taxes are related to business M income and which foreign taxes are related to business N income. Under paragraph (b)(4)(xi) of this section, \$40 of country X taxes is related to the \$100 of general limitation income from business M. Under paragraph (b)(4)(xi), the country Y tax imposed in year 2 is allocable to the \$50 of business N income AB recognizes in year 2 under country Y law and is treated as paid in year 2 on the \$50 of business N income recognized for U.S. tax purposes in year 1. See §1.904-6(a)(1)(iv) and (c), *Example 5*. Accordingly, the \$10 of country Y taxes is related to the \$50 of general limitation income from business N. Because AB's partnership agreement allocates the \$40 of country X taxes in proportion to the general limitation income from business M, and the \$10 of country Y taxes from business N in proportion to the year 1 general limitation income from business N, the allocations of the country X and country Y taxes are in proportion to the allocation of the income to which the foreign taxes relate. Therefore, AB's partnership agreement satisfies the requirement of paragraph (b)(4)(xi)(a)(2) of this section. Because AB also satisfies the requirements of paragraph (b)(4)(xi)(a)(1) of this section, the allocations of the country X and Y taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(xi) of this section.

*Example 28.* (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB's partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership. AB operates business M in country X. Assume that country X imposes a 20 percent tax on the net income from business M, which tax is a creditable foreign tax. In year 1, AB earns \$300 of gross income, has deductible expenses, exclusive of creditable foreign taxes, of \$100, and pays or accrues \$40 of country X tax. For purposes of section 904(d), all income from business M is general limitation income. Pursuant to the partnership agreement, the first \$100 of gross income each year is allocated to A as a return on excess capital contributed by A. All remaining partnership items, including creditable foreign taxes, are split evenly (50/50) between A and B. Assume that the gross income allocation is not deductible for country X purposes.

(ii) Under paragraph (b)(4)(xi) of this section, the \$40 of taxes is related to the \$200 of general limitation net income. In year 1, AB's partnership agreement allocates \$150 or 75 percent of the general limitation income to A (\$100 attributable to the gross income allocation plus \$50 of the remaining \$100 of net income) and \$50 or 25 percent of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the \$100 gross income allocation. Therefore, AB allocates the country X taxes 50 percent to A (\$20) and 50 percent to B (\$20). Under paragraph (b)(4)(xi) of this section, the allocation of country X taxes cannot have substantial

economic effect and must be allocated in accordance with the partners' interests in the partnership. AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(xi) of this section, because they are not in proportion to the allocation of the income to which the country X taxes relate.

(c) through (e)(4)(ii)(b) [Reserved]. For further guidance, see §1.704-1(c) through (e)(4)(ii)(b).

John M. Dalrymple,  
*Acting Deputy Commissioner for  
Services and Enforcement.*

Approved March 25, 2004.

Gregory F. Jenner,  
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on April 20, 2004, 8:45 a.m., and published in the issue of the Federal Register for April 21, 2004, 69 F.R. 21405)

## Section 1296.—Election of Mark to Market for Marketable Stock

26 CFR 1.1296-1: Mark to market election for marketable stock.

T.D. 9123

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### Electing Mark to Market for Marketable Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

**SUMMARY:** This document contains final regulations that provide procedures for certain United States persons holding marketable stock in a passive foreign investment company (PFIC) to elect mark to market treatment for that stock under section 1296 of the Internal Revenue Code and related provisions of sections 1291 and 1295. These final regulations affect United States persons owning marketable stock in a PFIC.

**DATES:** *Effective Date:* These regulations are effective May 3, 2004.

*Applicability Date:* For dates of applicability, see §§1.1291-1(j), 1.1295-1(k), and 1.1296-1(j).

FOR FURTHER INFORMATION CONTACT: Alexandra K. Helou, (202) 622-3840 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### Background

On July 31, 2002, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-112306-00, 2002-2 C.B. 767) under section 1296 and related provisions of the Internal Revenue Code (Code). Two written comments were received in response to the notice of proposed rulemaking. No public hearing was requested or held on the notice of proposed rulemaking. After consideration of the comments, the proposed regulations are adopted as final regulations with the modifications discussed below.

### Summary of Public Comments and Explanation of Changes

#### *A. Deferral of Post-October PFIC Losses by Regulated Investment Companies (RICs) Under section 852(b)(10)*

One commentator recommended that the regulations provide guidance regarding the determination of post-October “net reduction in value” of PFIC stock held by a RIC under section 852(b)(10). Section 852(b)(10) provides that taxable income of a RIC (other than a RIC to which an election under section 4982(e)(4) applies) shall be computed without regard to any net reduction in value occurring after October 31 of the taxable year of any stock of a PFIC with respect to which an election under section 1296(k) is in effect and that any such reduction shall be treated as occurring on the first day of the following taxable year.

To address concerns relating to a RIC’s post-October period, the commentator provided three recommendations. First, that the regulations clarify whether the deferral of post-October PFIC losses under section 852(b)(10) is elective or mandatory; second, that RICs be permitted to defer their post-October losses under rules similar to

those that apply to foreign currency gains and losses under §1.852-11; and third, that RICs be allowed to include actual post-October dispositions of PFIC stock when computing losses eligible for deferral.

The IRS and Treasury have considered these recommendations and determined that the issues raised with respect to section 852(b)(10) are issues under the RIC tax provisions that are beyond the scope of this regulations project.

#### *B. Situations Arising From Different Tax Years of RICs and the Foreign Corporations in Which They Invest*

One commentator requested guidance in instances where the RIC and a foreign corporation in which it invests have different or “mismatching” taxable years. This commentator noted that a RIC may experience uncertainties with respect to determining its taxable income and minimum distribution amount in situations where, following the end of its taxable year, the RIC learns that a foreign corporation in which it has invested is a PFIC or that the foreign corporation no longer satisfies the income or asset tests of section 1297(a) for the current taxable year. To address administrative concerns arising in this situation, this commentator recommended that RICs be permitted to recognize a change in a foreign corporation’s PFIC status in the RIC’s taxable year within which the taxable year of the foreign corporation ends.

Issues arising from different taxable years are not specific to PFICs for which a taxpayer has made a section 1296 election. Accordingly, this issue is beyond the scope of this regulations project. However, comments are requested for approaches that address issues arising when a taxpayer and a PFIC have different taxable years. Such issues may be addressed in a future regulations project.

#### *C. Situations Where a RIC Owns Stock in a Foreign Corporation That No Longer Satisfies the PFIC Definition in the Current Year*

One commentator suggested that the regulations should address certain issues that arise with respect to a shareholder that has made a section 1296 election for its PFIC stock and the foreign corporation

does not satisfy the income or asset test in section 1297(a) for the year. First, the commentator suggested that the regulations clarify that the character of gains from the disposition of the stock of the foreign corporation during the time that the corporation did not qualify as a PFIC should be capital gain. The commentator also requested that the regulations provide that the character of losses with respect to stock for which a section 1296 election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC be treated as ordinary income to the extent of any unreversed inclusions at the time of disposition.

After consideration of these comments, and in accordance with the statutory provisions of section 1296, the IRS and Treasury have adopted the first comment, but not the second comment. Accordingly, two examples were added to the regulations. *Example 2* in §1.1296-1(c)(7) clarifies that any gain from the disposition of stock of a foreign corporation that does not qualify as a PFIC for the year of disposition will be capital gain because section 1296(c)(1)(A) no longer applies at such time. In the case of losses with respect to stock for which a section 1296 election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC, *Example 4* in §1.1296-1(c)(7) was added to clarify that any loss from the disposition of such stock will be a capital loss because section 1296(c)(1)(B) no longer applies at such time.

Second, the commentator recommended that the regulations provide automatic consent for RICs to terminate a section 1296 election during a year that a foreign corporation no longer satisfies the requirements for PFIC status. The IRS and Treasury have not adopted this recommendation. The IRS and Treasury believe that it is appropriate to require consent of the Commissioner to terminate a section 1296 election. Under §1.1296-1(h)(3), a shareholder can request the consent of the Commissioner to revoke a section 1296 election upon a finding of a substantial change in circumstances, which may include a foreign corporation ceasing to be a PFIC.

*D. Technical Coordination Issues Arising From Marking PFIC Stock to Market Under the Former Proposed §1.1291-8 and Notice 92-53*

A commentator suggested that the regulations should clarify how the former proposed §1.1291-8 (see Notice 92-53, 1992-2 C.B. 384) and the current statutory PFIC mark to market rules under section 1296 interact. For example, the commentator requested clarification concerning the RIC's adjustments to the basis of its PFIC stock to reflect gains previously included under the former proposed §1.1291-8.

The IRS and Treasury believe that no additional clarification is needed. To the extent a taxpayer increased its basis or received a new holding period under the former proposed §1.1291-8, those consequences will be respected even though the proposed regulations were withdrawn without being finalized following the enactment of current section 1296 (see INTL-941-86, 1991-1 C.B. 1255 [64 FR 5015] (February 2, 1999) withdrawing proposed §1.1291-8). As a result, the suggestion was not adopted.

This same commentator also recommended that *Example 2* of proposed §1.1296-1(i)(4) be clarified by specifically providing that the RIC had not made a mark to market election under the former proposed §1.1291-8. The commentator suggested this modification to eliminate potential ambiguities that may arise over the relationship between an election under the former proposed §1.1291-8 and section 1296. This suggestion was adopted, and the example has been revised accordingly.

*E. The Regulations Should Allow Qualified Shareholders to Make Protective and Retroactive Mark to Market Elections*

One commentator recommended that the regulations should provide rules similar to those contained in the qualified electing fund (QEF) regime for purposes of making a retroactive QEF election. The IRS and Treasury have considered this comment and continue to believe that the appropriate process for retroactive relief for late mark to market elections is under the §301.9100 relief provisions, as set forth in §1.1296-1(h)(1)(iii). Accordingly, this suggestion was not adopted.

*F. Termination of Existing Section 1296 Mark to Market Elections Without the Consent of the Commissioner*

One commentator suggested permitting a taxpayer with an existing section 1296 election to make a QEF election and terminate its existing 1296 election without the consent of the Commissioner. The proposed regulations were structured to facilitate an election for mark to market treatment by permitting a taxpayer with an existing QEF election to make a section 1296 election and terminate the existing QEF election without requiring the consent of the Commissioner. Conversely, a taxpayer with an existing section 1296 election is permitted to make a QEF election only if the section 1296 election is terminated as provided by section 1296 and the regulations thereunder (e.g., if the PFIC stock ceases to be marketable) or is revoked with consent of the Commissioner. This approach reflects consideration of the relative administrative burdens imposed under each set of rules, and the stated intent of Congress that one of the purposes for enacting section 1296 was to provide another alternative to the interest charge rules of section 1291 that would be available in instances where taxpayers cannot obtain sufficient information to make a QEF election. See H.R. Rep. No. 105-148, at 533 (1997); S. Rep. No. 105-33 at 94 (1997). After consideration of the comment, the IRS and Treasury continue to believe the rules coordinating QEF elections and mark to market elections under section 1296 are appropriate for the reasons discussed above. Accordingly, this recommendation was not adopted.

*G. Proposals to Enhance the Utility of QEF Elections for RICs*

One commentator provided two suggestions focused on enhancing the utility of QEF elections for RICs. Specifically, the commentator first suggested allowing RICs to use U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS) for purposes of computing QEF inclusions under section 1295(a)(2). The commentator also suggested revising the retroactive QEF election rules in cases where a RIC learns of the PFIC status of a foreign corporation immediately prior

to the deadline for making a QEF election. These comments, which raise issues regarding the QEF rules, are beyond the scope of this regulation. Accordingly, these comments were not adopted but will be considered in the context of any guidance to be issued under the appropriate substantive provisions.

*H. Additional Revisions*

The final regulations also clarify that the regulations apply to taxable years beginning on or after May 3, 2004. Additionally, the several examples in proposed §1.1296-1(c) have been grouped together in new §1.1296-1(c)(7) in order to make the regulation more readable.

**Special Analysis**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal author of these regulations is Alexandra K. Helou, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

## PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.1296-1 also issued under 26 U.S.C. 1296(g) and 26 U.S.C. 1298(f). \* \* \*

Par. 2. § 1.1291-0 (table of contents) is amended by revising the introductory text and by adding the entries for § 1.1291-1 to read as follows:

*§ 1.1291-0 Treatment of shareholders of certain passive foreign investment companies; table of contents.*

This section contains a listing of the headings for §§ 1.1291-1, 1.1291-9, and 1.1291-10.

*§ 1.1291-1 Taxation of U.S. persons that are shareholders of section 1291 funds.*

(a) through (b) [Reserved].

(c) Coordination with other PFIC rules. (1) and (2) [Reserved].

(3) Coordination with section 1296: distributions and dispositions.

(4) Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296.

(i) In general.

(ii) Coordination rule.

(d) [Reserved].

(e) Exempt organization as shareholder. (1) In general.

(2) Effective date.

(f) through (i) [Reserved].

(j) Effective date.

\* \* \* \* \*

Par. 3. Section 1.1291-1 is amended by:

1. Revising paragraphs (a) through (d).

2. Adding paragraphs (f) through (j).

The revisions and additions read as follows:

*§ 1.1291-1 Taxation of U.S. persons that are shareholders of section 1291 funds.*

(a) and (b) [Reserved].

(c) *Coordination with other PFIC rules.* (1) and (2) [Reserved].

(3) *Coordination with section 1296: distributions and dispositions.* If PFIC stock is marked to market under section 1296 for any taxable year, then,

except as provided in § 1.1296-1(i), section 1291 and the regulations thereunder shall not apply to any distribution with respect to section 1296 stock (as defined in § 1.1296-1(a)(2)), or to any disposition of such stock, for such taxable year.

(4) *Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296—(i) In general.* If PFIC stock is marked to market for any taxable year under section 475 or any other provision of chapter 1 of the Internal Revenue Code, other than section 1296, regardless of whether the application of such provision is mandatory or results from an election by the taxpayer or another person, then, except as provided in paragraph (c)(4)(ii) of this section, section 1291 and the regulations thereunder shall not apply to any distribution with respect to such PFIC stock or to any disposition of such PFIC stock for such taxable year. See §§ 1.1295-1(i)(3) and 1.1296-1(h)(3)(i) for rules regarding the automatic termination of an existing election under section 1295 or section 1296 when a taxpayer marks to market PFIC stock under section 475 or any other provision of chapter 1 of the Internal Revenue Code.

(ii) *Coordination rule—(A)* Notwithstanding any provision in this section to the contrary, the rule of paragraph (c)(4)(ii)(B) of this section shall apply to the first taxable year in which a United States person marks to market its PFIC stock under a provision of chapter 1 of the Internal Revenue Code, other than section 1296, if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in section 1291(a)(3)(A) and § 1.1296-1(f)) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(B) For the first taxable year of a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Internal Revenue Code, other than section 1296, such United States person shall, in lieu of the rules under which the United States person marks to market, apply the rules of § 1.1296-1(i)(2) and (3) as if the United States person had made an election under section 1296 for such first taxable year.

(d) [Reserved].

\* \* \* \* \*

(f) through (i) [Reserved].

(j) *Effective dates.* This section applies for taxable years beginning on or after May 3, 2004, except as otherwise provided in paragraph (e)(2) of this section.

Par. 4. § 1.1295-0 (table of contents) is amended by:

1. Revising the entries for § 1.1295-1(i)(3) and (i)(4) and adding paragraph (i)(5), (i)(5)(i), and (i)(5)(ii).

2. Revising the entry for § 1.1295-1(k).

The revisions and addition read as follows:

*§ 1.1295-0 Table of contents.* \* \* \*

*§ 1.1295-1 Qualified electing funds.*

\* \* \* \* \*

(i) \* \* \*

(3) Automatic termination.

(4) Effect of invalidation, termination or revocation.

(5) Election after invalidation, termination or revocation.

(i) In general.

(ii) Special rule.

\* \* \* \* \*

(k) Effective dates.

\* \* \* \* \*

*§ 1.1295-1 Qualified electing funds.*

Par. 5. Section 1.1295-1 is amended by:

1. Redesignating paragraphs (i)(3) and (i)(4) as paragraphs (i)(4) and (i)(5), respectively.

2. Adding a new paragraph (i)(3).

3. Revising newly designated paragraph (i)(5).

4. Revising paragraph (k).

The revisions and addition read as follows:

*§ 1.1295-1 Qualified electing funds*

\* \* \* \* \*

(i) \* \* \*

(3) *Automatic termination.* If a United States person, or the United States shareholder on behalf of a controlled foreign corporation, makes an election pursuant to section 1296 and the regulations thereunder with respect to PFIC stock for which a QEF election is in effect, or marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, the

QEF election is automatically terminated with respect to such stock that is marked to market under section 1296 or another provision of chapter 1 of the Internal Revenue Code. Such termination shall be effective on the last day of the shareholder's taxable year preceding the first taxable year for which the section 1296 election is in effect or such stock is marked to market under another provision of chapter 1 of the Internal Revenue Code.

*Example.* Corp Y, a domestic corporation, owns directly 100 shares of marketable stock in foreign corporation FX, a PFIC. Corp Y also owns a 50 percent interest in FP, a foreign partnership that owns 200 shares of FX stock. Accordingly, under section 1298(a)(3) and §1.1296-1(e)(1), Corp Y is treated as indirectly owning 100 shares of FX stock. Corp Y also owns 100 percent of the stock of FZ, a foreign corporation that is not a PFIC. FZ owns 100 shares of FX stock, and therefore under section 1298(a)(2)(A), Corp Y is treated as owning the 100 shares of FX stock owned by FZ. For taxable year 2005, Corp Y has a QEF election in effect with respect to all 300 shares of FX stock that it owns directly or indirectly. See generally §1.1295-1(c)(1). For taxable year 2006, Corp Y makes a timely election pursuant to section 1296 and the regulations thereunder. For purposes of section 1296, Corp Y is treated as owning stock held indirectly through a partnership, but not through a foreign corporation. Section 1296(g); §1.1296-1(e)(1). Accordingly, Corp Y's section 1296 election covers the 100 shares it owns directly and the 100 shares it owns indirectly through FP, but not the 100 shares owned by FZ. With respect to the first 200 shares, Corp Y's QEF election is automatically terminated effective December 31, 2005. With respect to the 100 shares Corp Y owns through foreign FZ, Corp Y's QEF election remains in effect unless invalidated, terminated, or revoked pursuant to this paragraph (i).

\* \* \* \* \*

(5) *Effect after invalidation, termination, or revocation*—(i) *In general.* Without the Commissioner's consent, a shareholder whose section 1295 election was invalidated, terminated, or revoked under this paragraph (i) may not make the section 1295 election with respect to the PFIC before the sixth taxable year in which the invalidation, termination, or revocation became effective.

(ii) *Special rule.* Notwithstanding paragraph (i)(5)(i) of this section, a shareholder whose section 1295 election was terminated pursuant to paragraph (i)(3) of this section, and either whose section 1296 election has subsequently been terminated because its PFIC stock ceased to be marketable or who no longer marks to market such stock under another provision of chapter 1 of the Internal Revenue Code,

may make a section 1295 election with respect to its PFIC stock before the sixth taxable year in which its prior section 1295 election was terminated.

\* \* \* \* \*

(k) *Effective dates.* Except as otherwise provided, paragraphs (b)(2)(iii), (b)(3), (b)(4), and (c) through (j) of this section are applicable to taxable years of shareholders beginning after December 31, 1997. However, taxpayers may apply the rules under paragraphs (b)(4), (f) and (g) of this section to a taxable year beginning before January 1, 1998, provided the statute of limitations on the assessment of tax has not expired as of April 27, 1998, and, in the case of paragraph (b)(4) of this section, the taxpayers who filed the joint return have consistently applied the rules of that section to all taxable years following the year the election was made. Paragraph (b)(3)(v) of this section is applicable as of February 7, 2000, however, a taxpayer may apply the rules to a taxable year prior to the applicable date provided the statute of limitations on the assessment of tax for that taxable year has not expired. Paragraphs (i)(3) and (i)(5)(ii) of this section are applicable for taxable years beginning on or after May 3, 2004.

Par. 6. Section 1.1296-1 is added to read as follows:

*§1.1296-1 Mark to market election for marketable stock.*

(a) *Definitions*—(1) *Eligible RIC.* An eligible RIC is a regulated investment company that offers for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, or that publishes net asset valuations at least annually.

(2) *Section 1296 stock.* The term *section 1296 stock* means marketable stock in a passive foreign investment company (PFIC), including any PFIC stock owned directly or indirectly by an eligible RIC, for which there is a valid section 1296 election. Section 1296 stock does not include stock of a foreign corporation that previously had been a PFIC, and for which a section 1296 election remains in effect.

(3) *Unreversed inclusions*—(i) *General rule.* The term *unreversed inclusions* means with respect to any section 1296 stock, the excess, if any, of—

(A) The amount of mark to market gain included in gross income of the United States person under paragraph (c)(1) of this section with respect to such stock for prior taxable years; over

(B) The amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock for prior taxable years.

(ii) *Section 1291 adjustment.* The amount referred to in paragraph (a)(3)(i)(A) of this section shall include any amount subject to section 1291 under the coordination rule of paragraph (i)(2)(ii) of this section.

(iii) *Example.* An example of the computation of unreversed inclusions is as follows:

*Example.* A, a United States person, acquired stock in Corp X, a foreign corporation, on January 1, 2005, for \$150. At such time and at all times thereafter, Corp X was a PFIC and A's stock in Corp X was marketable. For taxable years 2005 and 2006, Corp X was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the X stock, effective for taxable year 2007. The fair market value of the X stock was \$200 as of December 31, 2006, and \$240 as of December 31, 2007. Additionally, Corp X made no distribution with respect to its stock for the taxable years at issue. In 2007, pursuant to paragraph (i)(2)(ii) of this section, A must include the \$90 gain in the X stock in accordance with the rules of section 1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions pursuant to paragraph (a)(3)(ii) of this section, A will include the \$90 of gain that was taxed under section 1291 and not the interest thereon.

(iv) *Special rule for regulated investment companies.* In the case of a regulated investment company which had elected to mark to market the PFIC stock held by such company as of the last day of the taxable year preceding such company's first taxable year for which such company makes a section 1296 election, the amount referred to in paragraph (a)(3)(i)(A) of this section shall include amounts previously included in gross income by the company pursuant to such mark to market election with respect to such stock for prior taxable years. For further guidance, see Notice 92-53, 1992-2 C.B. 384, (see also 601.601(d)(2) of this chapter).

(b) *Application of section 1296 election*—(1) *In general.* Any United States person and any controlled foreign corporation (CFC) that owns directly, or is treated as owning under this section, marketable stock, as defined in §1.1296-2, in a PFIC

may make an election to mark to market such stock in accordance with the provisions of section 1296 and this section.

(2) *Election applicable to specific United States person.* A section 1296 election applies only to the United States person (or CFC that is treated as a U.S. person under paragraph (g)(2) of this section) that makes the election. Accordingly, a United States person's section 1296 election will not apply to a transferee of section 1296 stock.

(3) *Election applicable to specific corporation only.* A section 1296 election is made with respect to a single foreign corporation, and thus a separate section 1296 election must be made for each foreign corporation that otherwise meets the requirements of this section. A United States person's section 1296 election with respect to stock in a foreign corporation applies to all marketable stock of the corporation that the person owns directly, or is treated as owning under paragraph (e) of this section, at the time of the election or that is subsequently acquired.

(c) *Effect of election*—(1) *Recognition of gain.* If the fair market value of section 1296 stock on the last day of the United States person's taxable year exceeds its adjusted basis, the United States person shall include in gross income for its taxable year the excess of the fair market value of such stock over its adjusted basis (mark to market gain).

(2) *Character of gain.* Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated as ordinary income.

(3) *Recognition of loss.* If the adjusted basis of section 1296 stock exceeds its fair market value on the last day of the United States person's taxable year, such person shall be allowed a deduction for such taxable year equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock (mark to market loss).

(4) *Character of loss*—(i) *Losses not in excess of unreversed inclusions.* Any mark to market loss allowed as a deduction under paragraph (c)(3) of this section, and any loss on the sale or other disposition of section 1296 stock, to the extent that such loss does not exceed the unreversed inclusions attributable to such stock, shall be treated as an ordinary loss, deductible in computing adjusted gross income.

(ii) *Losses in excess of unreversed inclusions.* Any loss recognized on the sale or other disposition of section 1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Internal Revenue Code and the regulations thereunder.

(5) *Application of election to separate lots of stock.* In the case in which a United States person purchased or acquired shares of stock in a PFIC at different prices, the rules of this section shall be applied in a manner consistent with the rules of §1.1012-1.

(6) *Source rules.* The source of any amount included in gross income under paragraph (c)(1) of this section, or the allocation and apportionment of any amount allowed as a deduction under paragraph (c)(3) of this section, shall be determined in the same manner as if such amounts were gain or loss (as the case may be) from the sale of stock in the PFIC.

(7) *Examples.* The following examples illustrate this paragraph (c):

*Example 1. Treatment of gain as ordinary income.* A, a United States individual, purchases stock in FX, a foreign corporation that is not a PFIC, in 1990 for \$1,000. On January 1, 2005, when the fair market value of the FX stock is \$1,100, FX becomes a PFIC. A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the FX stock is \$1,200. For taxable year 2005, A includes \$200 of mark to market gain (the excess of the fair market value of FX stock (\$1,200) over A's adjusted basis (\$1,000)) in gross income as ordinary income and pursuant to paragraph (d)(1) of this section increases his basis in the FX stock by that amount.

*Example 2. Treatment of gain as capital gain.* The facts are the same as in *Example 1*. For taxable year 2006, FX does not satisfy either the asset test or the income test of section 1297(a). A does not revoke the section 1296 election it made with respect to the FX stock. On December 1, 2006, A sells the FX stock when the fair market value of the stock is \$1,500. For taxable year 2006, A includes \$300 of gain (the excess of the fair market value of FX stock (\$1,500) over A's adjusted basis (\$1,200)) in gross income as long-term capital gain because at the time of sale of the FX stock by A, FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period for non-PFIC purposes was more than one year.

*Example 3. Treatment of losses as ordinary where they do not exceed unreversed inclusions.* The facts are the same as in *Example 1*. On December 1, 2006, A sells the stock in FX for \$1,100. At that time, A's unreversed inclusions (the amount A included in income as mark to market gain) with respect to the stock in FX are \$200. Accordingly, for taxable year 2006, A recognizes a loss on the sale of the FX stock of

\$100, (the fair market value of the FX stock (\$1,100) minus A's adjusted basis (\$1,200) in the stock) that is treated as an ordinary loss because the loss does not exceed the unreversed inclusions attributable to the stock of FX.

*Example 4. Treatment of losses as long-term capital losses.* The facts are the same as in *Example 3*, except that FX does not satisfy either the asset test or the income test of section 1297(a) for taxable year 2006. For taxable year 2006, A's \$100 loss from the sale of the FX stock is treated as long-term capital loss because at the time of the sale of the FX stock by A FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period in the FX stock for non-PFIC purposes was more than one year.

*Example 5. Long-term capital loss treatment of losses in excess of unreversed inclusions.* The facts are the same as in *Example 3*, except that A sells his FX stock for \$900. At the time of A's sale of the FX stock on December 1, 2006, A's unreversed inclusions with respect to the FX stock are \$200. Accordingly, the \$300 loss recognized by A on the disposition is treated as an ordinary loss to the extent of his unreversed inclusions (\$200). The amount of the loss in excess of A's unreversed inclusions (\$100) will be treated as a long-term capital loss because A's holding period in the FX stock for non-PFIC purposes was more than one year.

*Example 6. Application of section 1296 election to separate lots of stock.* On January 1, 2005, Corp A, a domestic corporation, purchased 100 shares (first lot) of stock in FX, a PFIC, for \$500 (\$5 per share). On June 1, 2005, Corp A purchased 100 shares (second lot) of FX stock for \$1,000 (\$10 per share). Corp A made a timely section 1296 election with respect to its FX stock for taxable year 2005. On December 31, 2005, the fair market value of FX stock was \$8 per share. For taxable year 2005, Corp A includes \$300 of gain in gross income as ordinary income under paragraph (c)(1) of this section with respect to the first lot, and adjusts its basis in that lot to \$800 pursuant to paragraph (d)(1) of this section. With respect to the second lot, Corp A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year 2005. Although Corp A's adjusted basis in that stock exceeds its fair market value by \$200, Corp A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2006, Corp A sells 100 shares of FX stock for \$900. Assuming that Corp A adequately identifies (in accordance with the rules of §1.1012-1(c)) the shares of FX stock sold as being from the second lot, Corp A recognizes \$100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

(d) *Adjustment to basis*—(1) *Stock held directly.* The adjusted basis of the section 1296 stock shall be increased by the amount included in the gross income of the United States person under paragraph (c)(1) of this section with respect to such stock, and decreased by the amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock.

(2) *Stock owned through certain foreign entities.* (i) In the case of section

1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the basis adjustments under paragraph (d)(1) of this section shall apply to such stock in the hands of the foreign entity actually holding such stock, but only for purposes of determining the subsequent treatment under chapter 1 of the Internal Revenue Code of the United States person with respect to such stock. Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person's interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

(ii) *Example.* The following example illustrates this paragraph (d)(2):

*Example.* FP is a foreign partnership. Corp A, a domestic corporation, owns a 20 percent interest in FP. Corp B, a domestic corporation, owns a 30 percent interest in FP. Corp C, a foreign corporation, with no direct or indirect shareholders that are U.S. persons, owns a 50% interest in FP. Corp A, Corp B, and FP all use a calendar year for their taxable year. In 2005, FP purchases stock in FX, a foreign corporation and a PFIC, for \$1,000. Corp A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the PFIC stock is \$1,100. Corp A includes \$20 of ordinary income in taxable year 2005 under paragraphs (c)(1) and (2) of this section. Corp A increases its basis in its FP partnership interest by \$20. FP increases its basis in the FX stock to \$1,020 solely for purposes of determining the subsequent treatment of Corp A, under chapter 1 of the Internal Revenue Code, with respect to such stock. In 2006, FP sells the FX stock for \$1,200. For purposes of determining the amount of gain of Corp A, FP will be treated as having \$180 in gain of which \$20 is allocated to Corp A. Corp A's \$20 of gain will be treated as ordinary income under paragraph (c)(2) of this section. For purposes of determining the amount of gain attributable to Corp B, FP will be treated as having \$200 gain, \$60 of which will be allocated to Corp B.

(3) *Stock owned indirectly by an eligible RIC.* Paragraph (d)(2) of this section shall also apply to an eligible RIC which is an indirect shareholder under § 1.1296-2(f) of stock in a PFIC and has a valid section 1296 election in effect with respect to the PFIC stock.

(4) *Stock acquired from a decedent.* In the case of stock of a PFIC which is acquired by bequest, devise, or inheritance (or by the decedent's estate) and with re-

spect to which a section 1296 election was in effect as of the date of the decedent's death, notwithstanding section 1014, the basis of such stock in the hands of the person so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis which would have been determined under section 1014 without regard to this paragraph).

(5) *Transition rule for individuals becoming subject to United States income taxation—(i) In general.* If any individual becomes a United States person in a taxable year beginning after December 31, 1997, solely for purposes of this section, the adjusted basis, before adjustments under this paragraph (d), of any section 1296 stock owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value or its adjusted basis on such first day.

(ii) An example of the transition rule for individuals becoming subject to United States income taxation is as follows:

*Example.* A, a nonresident alien individual, purchases marketable stock in FX, a PFIC, for \$50 in 1995. On January 1, 2005, A becomes a United States person and makes a timely section 1296 election with respect to the stock in accordance with paragraph (h) of this section. The fair market value of the FX stock on January 1, 2005, is \$100. The fair market value of the FX stock on December 31, 2005, is \$110. Under paragraph (d)(5)(i) of this section, A computes the amount of mark to market gain or loss for the FX stock in 2005 by reference to an adjusted basis of \$100, and therefore A includes \$10 in gross income as mark to market gain under paragraph (c)(1) of this section. Additionally, under paragraph (d)(1) of this section, A's adjusted basis in the FX stock for purposes of this section is increased to \$110 (and to \$60 for all other tax purposes). A sells the FX stock in 2006 for \$120. For purposes of applying section 1001, A must use its original basis of \$50, with any adjustments under paragraph (d)(1) of this section, \$10 in this case, and therefore A recognizes \$60 of gain. Under paragraph (c)(2) of this section (which is applied using an adjusted basis of \$110), \$10 of such gain is treated as ordinary income. The remaining \$50 of gain from the sale of the FX stock is long term capital gain because A held such stock for more than one year.

(e) *Stock owned through certain foreign entities—(1) In general.* Except as provided in paragraph (e)(2) of this section, the following rules shall apply in determining stock ownership for purposes of this section. PFIC stock owned, directly or indirectly, by or for a foreign partnership, foreign trust (other than a foreign trust described in sections 671 through 679), or foreign estate shall be considered as be-

ing owned proportionately by its partners or beneficiaries. PFIC stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679 shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock. The determination of a person's proportionate interest in a foreign partnership, foreign trust or foreign estate will be made on the basis of all the facts and circumstances. Stock considered owned by reason of this paragraph shall, for purposes of applying the rules of this section, be treated as actually owned by such person.

(2) *Stock owned indirectly by eligible RICs.* The rules for attributing ownership of stock contained in § 1.1296-2(f) will apply to determine the indirect ownership of PFIC stock by an eligible RIC.

(f) *Holding period.* Solely for purposes of sections 1291 through 1298, if section 1296 applied to stock with respect to the taxpayer for any prior taxable year, the taxpayer's holding period in such stock shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied.

(g) *Special rules—(1) Certain dispositions of stock.* To the extent a United States person is treated as actually owning stock in a PFIC under paragraph (e) of this section, any disposition which results in the United States person being treated as no longer owning such stock, and any disposition by the person owning such stock, shall be treated as a disposition by the United States person of the stock in the PFIC.

(2) *Treatment of CFC as a United States person.* In the case of a CFC that owns, or is treated as owning under paragraph (e) of this section, section 1296 stock:

(i) Other than with respect to the sourcing rules in paragraph (c)(6) of this section, this section shall apply to the CFC in the same manner as if such corporation were a United States person. The CFC will be treated as a foreign person for purposes of applying the source rules of paragraph (c)(6).

(ii) For purposes of subpart F of part III of subchapter N of the Internal Revenue Code—

(A) Amounts included in the CFC's gross income under paragraph (c)(1) or



(i)(2)(ii) of this section shall be treated as foreign personal holding company income under section 954(c)(1)(A); and

(B) Amounts allowed as a deduction under paragraph (c)(3) of this section shall be treated as a deduction allocable to foreign personal holding company income for purposes of computing net foreign base company income under §1.954-1(c).

(iii) A United States shareholder, as defined in section 951(b), of the CFC shall not be subject to section 1291 with respect to any stock of the PFIC for the period during which the section 1296 election is in effect for that stock, and the holding period rule of paragraph (f) of this section shall apply to such United States shareholder.

(iv) The rules of this paragraph (g)(2) shall not apply to a United States person that is a shareholder of the PFIC for purposes of section 1291, but is not a United States shareholder under section 951(b) with respect to the CFC making a section 1296 election.

(3) *Timing of inclusions for stock owned through certain foreign entities.* In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the mark to market gain or mark to market loss is determined in accordance with paragraphs (c) and (i)(2)(ii) of this section as of the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then included in the taxable year of such United States person that includes the last day of the taxable year of the entity.

(h) *Elections—(1) Timing and manner for making a section 1296 election—(i) United States persons.* A United States person that owns marketable stock in a PFIC, or is treated as owning marketable stock under paragraph (e) of this section, on the last day of the taxable year of such person, and that wants to make a section 1296 election, must make a section 1296 election for such taxable year on or before the due date (including extensions) of the United States person's income tax return for that year. The section 1296 election must be made on the Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund", included with the original tax return of the United States person for that year, or on an amended return, provided

that the amended return is filed on or before the election due date.

(ii) *Controlled foreign corporations.* A section 1296 election by a CFC shall be made by its controlling United States shareholders, as defined in §1.964-1(c)(5), and shall be included with the Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations", for that CFC by the due date (including extensions) of the original income tax returns of the controlling United States shareholders for that year. A section 1296 election by a CFC shall be binding on all United States shareholders of the CFC.

(iii) *Retroactive elections for PFIC stock held in prior years.* A late section 1296 election may be permitted only in accordance with §301.9100 of this chapter.

(2) *Effect of section 1296 election—(i)* A section 1296 election will apply to the taxable year for which such election is made and remain in effect for each succeeding taxable year unless such election is revoked or terminated pursuant to paragraph (h)(3) of this section.

(ii) *Cessation of a foreign corporation as a PFIC.* A United States person will not include mark to market gain or loss pursuant to paragraph (c) of this section with respect to any stock of a foreign corporation for any taxable year that such foreign corporation is not a PFIC under section 1297 or treated as a PFIC under section 1298(b)(1) (taking into account the holding period rule of paragraph (f) of this section). Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1296 election. Thus, if a foreign corporation is a PFIC in a taxable year after a year in which it is not treated as a PFIC, the United States person's original election (unless revoked or terminated in accordance with paragraph (h)(3) of this section) continues to apply and the shareholder must include any mark to market gain or loss in such year.

(3) *Revocation or termination of election—(i) In general.* A United States person's section 1296 election is terminated if the section 1296 stock ceases to be marketable; if the United States person elects, or is required, to mark to market the section 1296 stock under another provision of chapter 1 of the Internal Revenue Code; or if the Commissioner, in the Commissioner's discretion, consents to the United States person's request to revoke its sec-

tion 1296 election upon a finding of a substantial change in circumstances. A substantial change in circumstances for this purpose may include a foreign corporation ceasing to be a PFIC.

(ii) *Timing of termination or revocation.* Where a section 1296 election is terminated automatically (e.g., the stock ceases to be marketable), section 1296 will cease to apply beginning with the taxable year in which such termination occurs. Where a section 1296 election is revoked with the consent of the Commissioner, section 1296 will cease to apply beginning with the first taxable year of the United States person after the revocation is granted unless otherwise provided by the Commissioner.

(4) *Examples.* The operation of the rules of this paragraph (h) is illustrated by the following examples:

*Example 1.* A, a United States person, owns stock in FX, a PFIC. A makes a QEF election in 1996 with respect to the FX stock. For taxable year 2005, A makes a timely section 1296 election with respect to its stock, and thus its QEF election is automatically terminated pursuant to §1.1295-1(i)(3). In 2006, A's stock in FX ceases to be marketable, and therefore its section 1296 election is automatically terminated under paragraph (h)(3) of this section. Beginning with taxable year 2006, A is subject to the rules of section 1291 with respect to its FX stock unless it makes a new QEF election. See §1.1295-1(i)(5).

*Example 2.* The facts are the same as in *Example 1*, except that A's stock in FX becomes marketable again in 2007. A may make a new section 1296 election with respect to the FX stock for its taxable year 2007, or thereafter. A will be subject to the coordination rules under paragraph (i) of this section unless it made a new QEF election in 2006.

(i) *Coordination rules for first year of election—(1) In general.* Notwithstanding any provision in this section to the contrary, the rules of this paragraph (i) shall apply to the first taxable year in which a section 1296 election is effective with respect to marketable stock of a PFIC if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in paragraph (f) of this section) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(2) *Shareholders other than regulated investment companies.* For the first taxable year of a United States person (other than a regulated investment company) for which a section 1296 election is in effect with respect to the stock of a PFIC, such United



States person shall, in lieu of the rules of paragraphs (c) and (d) of this section—

(i) Apply the rules of section 1291 to any distributions with respect to, or disposition of, section 1296 stock;

(ii) Apply section 1291 to the amount of the excess, if any, of the fair market value of such section 1296 stock on the last day of the United States person's taxable year over its adjusted basis, as if such amount were gain recognized from the disposition of stock on the last day of the taxpayer's taxable year; and

(iii) Increase its adjusted basis in the section 1296 stock by the amount of excess, if any, subject to section 1291 under paragraph (i)(2)(ii) of this section.

(3) *Shareholders that are regulated investment companies.* For the first taxable year of a regulated investment company for which a section 1296 election is in effect with respect to the stock of a PFIC, such regulated investment company shall increase its tax under section 852 by the amount of interest that would have been imposed under section 1291(c)(3) for such taxable year if such regulated investment company were subject to the rules of paragraph (i)(2) of this section, and not this paragraph (i)(3). No deduction or increase in basis shall be allowed for the increase in tax imposed under this paragraph (i)(3).

(4) The operation of the rules of this paragraph (i) is illustrated by the following examples:

*Example (1).* A, a United States person and a calendar year taxpayer, owns marketable stock in FX, a PFIC that it acquired on January 1, 1992. At all times, A's FX stock was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election effective for taxable year 2005. At the close of taxable year 2005, the fair market value of A's FX stock exceeded its adjusted basis by \$10. Pursuant to paragraph (i)(2)(ii) of this section, A must treat the \$10 gain under section 1291 as if the FX stock were disposed of on December 31, 2005. Further, A increases its adjusted basis in the FX stock by the \$10 in accordance with paragraph (i)(2)(iii) of this section.

*Example (2).* Assume the same facts as in *Example (1)*, except that A is a RIC that had not made an election prior to 2005 to mark to market the PFIC stock. In taxable year 2005, A includes \$10 of ordinary income under paragraph (c)(1) of this section, and such amount is not subject to section 1291. A also increases its tax imposed under section 852 by the amount of interest that would have been determined under section 1291(c)(3), and no deduction is permitted for such amount. Finally, under paragraph (d)(1) of this section, A increases its adjusted basis in the FX stock by \$10.

(j) *Effective date.* The provisions in this section are applicable for taxable years beginning on or after May 3, 2004.

Par. 7. Section 1.1296(e)–1 is redesignated as §1.1296–2 and amended by:

1. Revising paragraph (b)(2).

2. Adding paragraph (b)(3).

3. Revising both references to “sections 958(a)(1) and (2)” in paragraph (f)(1) to read “section 1298(a)”.

The revisions and addition read as follows:

*§1.1296–2 Definition of marketable stock.*

\* \* \* \* \*

(b) \* \* \*

(2) *Special rule for year of initial public offering.* For the calendar year in which a corporation initiates a public offering of a class of stock for trading on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, such class of stock meets the requirements of paragraph (b)(1) of this section for such year if the stock is regularly traded on such exchanges or markets, other than in *de minimis* quantities, on 1/6 of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the taxpayer's calendar year. In cases where a corporation initiates a public offering of a class of stock in the fourth quarter of the calendar year, such class of stock meets the requirements of paragraph (b)(1) of this section in the calendar year of the offering if the stock is regularly traded on such exchanges or markets, other than in *de minimis* quantities, on the greater of 1/6 of the days remaining in the quarter in which the offering occurs, or 5 days.

(3) *Anti-abuse rule.* Trades that have as one of their principal purposes the meeting of the trading requirements of paragraph (b)(1) or (2) of this section shall be disregarded. Further, a class of stock shall not be treated as meeting the trading requirement of paragraph (b)(1) or (2) of this section if there is a pattern of trades conducted to meet the requirement of paragraph (b)(1) or (2) of this section. Similarly, paragraph (b)(2) of this section shall not apply to a public offering of stock that has as one of its principal purposes to avail itself of the reduced trading requirements under the special rule for the calendar year of an initial public offering.

For purposes of applying the immediately preceding sentence, consideration will be given to whether the trading requirements of paragraph (b)(1) of this section are satisfied in the subsequent calendar year.

\* \* \* \* \*

Par. 8. Section 1.6031(a)–1 is amended by:

1. Redesignating the text of paragraph (b)(1) as (b)(1)(i).

2. Adding a heading to newly designated paragraph (b)(1)(i).

3. Adding paragraph (b)(1)(ii).

The additions read as follows:

*§1.6031(a)–1 Return of Partnership income.*

\* \* \* \* \*

(b) \* \* \* (1) \* \* \* (i) *Filing requirement.*

\* \* \*

(ii) *Special rule.* For purposes of this paragraph (b)(1) and paragraph (b)(3)(iii) of this section, a foreign partnership will not be considered to have derived income from sources within the United States solely because a U.S. partner marks to market his *pro rata* share of PFIC stock held by the foreign partnership pursuant to an election under section 1296.

\* \* \* \* \*

Mark E. Matthews,  
Deputy Commissioner for  
Services and Enforcement.

Approved April 7, 2004.

Gregory F. Jenner,  
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 30, 2004, 8:45 a.m., and published in the issue of the Federal Register for May 3, 2004, 69 F.R. 24071)

## Section 6050N.—Returns Regarding Payments of Royalties

26 CFR 1.6050N–1: Statements to recipients of royalties.

(Also: 6041, 1.6041–1.)

### Royalties; information reporting.

This ruling provides guidance concerning the reporting requirements of sections 6041 and 6050N of the Code for payments by publishers to literary agents on behalf of an author.

**ISSUES**

What is the correct information reporting for royalty payments made by a publisher for the rights to an author's book or other literary composition if such royalties are paid to the author's literary agent who then forwards all or part of such payments to the author?

**FACTS**

A publisher enters into a contract for the license to use an author's literary works. The author is an individual. Pursuant to the contract, the publisher pays the author's royalties directly to the author's literary agent. The literary agent, upon receiving the royalties, subtracts his commission and expenses and then forwards the balance to the author pursuant to a contract between the literary agent and the author. During calendar year 2004, the royalties paid by the publisher exceeded \$10.

**LAW AND ANALYSIS**

Section 6041 of the Internal Revenue Code provides that all persons engaged in a trade or business who make a payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year shall render a true and accurate return setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Section 1.6041-1(a)(1)(i) of the Income Tax Regulations provides that the payments required to be reported under section 6041 include the following: (1) salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating \$600 or more; and (2) interest, rents, royalties, annuities, pensions, and other gains, profits, and income aggregating \$600 or more. The return of information required by section 1.6041-1(a)(1)(i) must be made on Form 1099. *See* section 1.6041-1(a)(2).

Sections 6041(a) and 1.6041-1(a)(ii) provide that payments for which an information return is required by, or under the authority of, section 6050N(a) (relating

to royalties), are not subject to reporting under section 1.6041-1(a)(1)(i).

Section 6050N(a) provides that every person who: (1) makes payments of royalties (or similar amounts) aggregating \$10 or more to any other person during any calendar year, or (2) receives payments of royalties (or similar amounts) as a nominee and who makes payments aggregating \$10 or more during any calendar year to any other person with respect to the royalties (or similar amounts) so received, shall file a return setting forth the aggregate amount of such payments and the name and address of the recipient of such payment. Section 6050N(b) provides that every person required to make a return under section 6050N(a) must furnish a statement to each person whose name is required to be set forth in such return. Form 1099-MISC is used for this reporting requirement.

The legislative history to section 6050N provides that section 6050N applies to royalty payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, books and other literary compositions. *See* H.R. Conf. Rep. No. 99-841, 99<sup>th</sup> Cong., 2<sup>nd</sup> Sess. II-788-789 (1986), 1986-3 (Vol. 4) C.B. 788-789.

Section 6050N(c) provides that section 6050N does not apply to any amount paid to a person described in section 6049(b)(4)(A) through (F). Section 6049(b)(4)(A) describes a corporation as such a person.

Section 1.6050N-1(c)(2) provides that the term payor shall have the meaning ascribed to it under section 1.6049-4(a). Section 1.6049-4(a)(2) defines a payor as a person who: (1) makes a payment of the type and of the amount subject to reporting under section 6049 (or under an applicable section of 26 CFR chapter 1) to any other person during a calendar year; or (2) collects on behalf of another person payments of the type and of the amount subject to reporting under section 6049 (or under an applicable section of 26 CFR chapter 1), or who otherwise acts as a middleman (as defined in paragraph (f)(4) of section 6049) with respect to such payment.

Based on the facts described above, both the publisher and the literary agent are payors of royalties for purposes of section 6050N. The royalty payments made by the publisher to the literary agent and

the royalty payments made by the literary agent to the author thus are not reportable under section 6041 and the regulations thereunder because such payments are payments to which 6050N applies. The publisher must file Form 1099-MISC reporting payments of royalties to the literary agent pursuant to section 6050N. If the literary agent is a corporation, no Form 1099-MISC is required pursuant to sections 6050N(c) and 6049(b)(4)(A). The literary agent must file a Form 1099-MISC for the royalties paid to the author regardless of whether the literary agent receives a Form 1099-MISC from the publisher.

Section 301.6011-1(b) provides that the Internal Revenue Service may prescribe in forms, instructions, or other appropriate guidance the information or documentation required to be included with any return. The instructions to Form 1099-MISC provide that gross royalties (before reduction for fees, commissions, or expenses) paid by a publisher directly to an author or literary agent or paid by a literary agent to an author must be reported on Form 1099-MISC. Thus, although the literary agent may have subtracted commissions and expenses before making the payment to the author, the Form 1099-MISC required to be filed by the literary agent must report the gross amount of royalties received from the publisher pursuant to section 6050N.

Payments by a publisher to a literary agent for an author's services (*e.g.*, speaker fees) that do not constitute royalties are not reportable under section 6050N. The information reporting for such payments is governed by section 6041 and the regulations thereunder. In such case, section 1.6041-1(e) would apply to determine whether the literary agent or the publisher must report the fees to the author. *See* sections 1.6041-1(e)(i) and 1.6041-1(e)(5), *Example 6*.

**HOLDING**

Pursuant to section 6050N, a publisher who makes royalty payments to a literary agent for the rights to an author's book or other literary composition must file an information return with respect to the payments to the literary agent unless the literary agent is a corporation. In addition, the literary agent (whether or not a corporation) who receives such payments and for-

wards all or part of such payments to the author must file an information return reporting the gross amount of royalty payments pursuant to section 6050N.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Tiffany P. Smith of the Office of Associate Chief Counsel (Procedure

and Administration). For further information regarding this revenue ruling, contact Tiffany P. Smith at (202) 622-4910 (not a toll-free call).

# Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.  
(Also Part I, §§ 132, 162, 274; 1.132–6.)

## Rev. Proc. 2004–29

### SECTION 1. PURPOSE

This revenue procedure provides the statistical sampling methodology that a taxpayer may use in establishing the amount of substantiated meal and entertainment expenses excepted from the 50% deduction disallowance of § 274(n)(1) of the Internal Revenue Code by reason of § 274(n)(2)(A), (B), (C), (D), or (E).

### SECTION 2. BACKGROUND

.01 Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including certain expenses for meals and entertainment.

.02 Section 274(d) disallows a § 162 deduction for any expense for travel (including meals and lodging while away from home), entertainment, gifts, or listed property unless the taxpayer substantiates the elements of the expense by adequate records or by sufficient evidence. See § 1.274–5T of the Income Tax Regulations.

.03 Section 274(n)(1) provides that the amount allowable as a deduction for any expense for food or beverages, or any item with respect to an activity that is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with these activities, may not exceed 50% of the amount of the expense.

.04 Section 274(n)(2)(A) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to expenses described in § 274(e)(2) (expenses treated on the taxpayer's return as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24), (e)(3) (expenses paid or incurred under a reimbursement or similar arrangement in connection with the performance of services), (e)(4) (recreational and similar expenses for employees),

(e)(7) (expenses relating to items available to the public), (e)(8) (expenses relating to entertainment sold to customers), or (e)(9) (expenses includible in income of persons who are not employees).

.05 Section 274(n)(2)(B) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to an expense for food or beverages that is excludable from the gross income of the recipient under § 132(e) (relating to *de minimis* fringe benefits excluded from income under § 132(a)(4)).

.06 Section 132(e) defines a *de minimis* fringe as any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. Under § 1.132–6(c), a cash fringe benefit (other than overtime meal money and local transportation fare) is never excludable as a *de minimis* fringe benefit. For example, expenses for meals and entertainment reimbursed to employees under an accountable plan (as defined in § 1.62–2(c)(2)) do not qualify as *de minimis* fringe benefits.

.07 Section 1.132–6(b) provides that the frequency with which similar fringes are provided by the employer to the employer's employees is generally determined by reference to the frequency with which the employer provides the fringes to each individual employee. However, if it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the workforce as a whole. This exception to the employee-measured frequency requirement does not apply to overtime meals, meal money, or local transportation fare.

.08 Section 274(n)(2)(C) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to an expense covered by a package involving a ticket described in § 274(l)(1)(B) (exception for certain charitable sports events).

.09 Section 274(n)(2)(D) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to taxable

payments or reimbursements of moving expenses of an employee by the employer.

.10 Section 274(n)(2)(E) provides that the 50% deduction disallowance of § 274(n)(1) does not apply to expenses for food or beverages (i) required by Federal law to be provided to crew members of a commercial vessel, (ii) provided to crew members of certain commercial vessels, or (iii) provided on or in proximity to certain oil or gas platforms or drilling rigs.

### SECTION 3. SCOPE

This revenue procedure applies to a taxpayer filing an original return, under examination, in litigation, or making a refund claim that desires to establish with respect to its income tax liability the amount of substantiated expenses paid or incurred for meals and entertainment excepted from the 50% deduction disallowance of § 274(n)(1) by reason of § 274(n)(2)(A), (B), (C), (D), or (E).

### SECTION 4. APPLICATION

.01 *In general.* A taxpayer filing an original return, under examination, in litigation, or making a refund claim, may use statistical sampling in connection with establishing, with respect to its income tax liability, the amount of the taxpayer's substantiated expenses paid or incurred for meals and entertainment excepted from the 50% deduction disallowance of § 274(n)(1) by reason of § 274(n)(2)(A), (B), (C), (D), or (E) by following the procedures provided in Appendix A (Sampling Plan Standards), Appendix B (Sampling Documentation Standards), Appendix C (Technical Formulas), and (in the case of *de minimis* fringes) in paragraph 4.02 of this revenue procedure.

.02 *Additional procedures required for de minimis fringe benefits.*

(1) *Reimbursements under accountable plans.* In conducting the study, expenses for meals and entertainment reimbursed by employers to employees under an accountable plan may not be treated as *de minimis* fringe benefits.

(2) *Determination of frequency.* To establish the amount of identified expenses that are excepted from § 274(n)(1) by reason of § 274(n)(2)(B), a taxpayer is required to determine the frequency with

which similar fringes were provided by the taxpayer to the taxpayer's employees on an employee-measured or employer-measured basis, as described in paragraphs (3) and (4) below. Thus, after selecting a statistical sample, as discussed below, the taxpayer may be required to review documentation from outside both the sample and the target population (the set of items from which the sample is drawn) to identify similar fringes included in employees' gross income and similar fringes previously excluded from employees' gross income as *de minimis* fringe benefits.

(3) *Employee-measured frequency.*

(a) *In general.* When using employee-measured frequency to determine the amount of identified expenses that are excepted from § 274(n)(1) by reason of § 274(n)(2)(B), the taxpayer must establish the frequency with which similar fringes were provided to each individual employee of the taxpayer. Therefore, after identifying the statistical sample, the taxpayer must review the remainder of the target population (and records that document similar fringes that are not included in the target population) to identify the aggregate number of similar fringes provided to the individual employees included in the statistical sample.

(b) *Example.* Taxpayer maintains a meal and entertainment expense account that includes invoices for meals provided in-kind to Taxpayer's employees that may be *de minimis* fringe benefits. The invoices specifically identify the employees who received the in-kind meals. Therefore, it would not be administratively difficult to determine the frequency with which in-kind meals were provided to individual employees, and Taxpayer must determine the frequency with which it provided in-kind meals to each of the individual employees included in the sample. Taxpayer has no other accounts that include expenses for in-kind meals provided to employees.

Taxpayer selects a statistical sample of the meal and entertainment expense account that identifies 10 employees who have received in-kind meals. In order to determine if the meals are *de minimis* fringes, Taxpayer must review documentation (such as invoices) in the remainder of the target population to identify all in-kind meals provided to each of the

10 individual employees included in the sample. Taxpayer must consider in-kind meals that Taxpayer included in each employee's gross income and similar fringes previously excluded from the employees' gross income as *de minimis* fringe benefits in determining the frequency with which similar fringes were provided to each of the 10 employees. After conducting this review, Taxpayer determines (after considering both the value and frequency of the meals) that the meals provided to 4 of the 10 employees in the sample are *de minimis* fringe benefits not subject to the 50% deduction disallowance of § 274(n)(1). Taxpayer may increase proportionately the deductible amount of expenses in the population not subject to the § 274(n)(1) limitation. See paragraph 6 of Appendix A.

(4) *Employer-measured frequency.*

(a) *In general.* When using employer-measured frequency to determine the amount of identified expenses that are excepted from § 274(n)(1) by reason of § 274(n)(2)(B), the taxpayer must establish the frequency with which similar fringes were provided to the taxpayer's workforce as a whole. Thus, the target population must include all relevant records prior to selection of the statistical sample in order to determine the aggregate number of similar fringes provided to all eligible employees and the aggregate number of employees eligible to receive such fringes.

(b) *Example.* Taxpayer maintains a meal and entertainment expense account that includes invoices for meals provided in-kind to Taxpayer's employees that may be *de minimis* fringe benefits. The invoices are for in-kind meals of a type for which it is administratively difficult to identify the particular employees who received the meals, and the invoices do not specifically identify those employees. Therefore, it would be administratively difficult to determine the frequency with which in-kind meals were provided to individual employees, and Taxpayer may determine the frequency with which similar fringes were provided by Taxpayer to Taxpayer's employees by reference to all employees eligible to receive in-kind meals. Taxpayer maintains an account in addition to the meal and entertainment expense account that includes expenses for in-kind meals provided to employees.

Taxpayer's workforce includes 500 employees who are eligible to receive the fringe benefit of in-kind meals.

Taxpayer merges the meal and entertainment expense account and the other account that includes expenses for in-kind meals to create a target population that includes all relevant records and conducts a statistical sample of the merged accounts. In determining whether the in-kind meals included in the sample are *de minimis* fringes, Taxpayer must consider in-kind meals that Taxpayer included in eligible employees' gross income and similar fringes previously excluded from employees' gross income as *de minimis* fringe benefits. Taxpayer identifies in the sample 50 in-kind meals provided to employees. The 50 meals represent 1000 in-kind meals in the target population as a whole, or two meals per eligible employee. Assuming that the provision of two meals with a given cost per eligible employee results in a value that is so small as to make accounting for it unreasonable or administratively impracticable, Taxpayer may treat all of the in-kind meals in the meal and entertainment expense account as *de minimis* fringe benefits not subject to the 50% deduction disallowance of § 274(n)(1), subject, however, to a *pro rata* reduction to the extent that any in-kind meals are evaluated under employee-measured frequency and fail to qualify as *de minimis* fringes.

.03 *Limitations.*

(1) This revenue procedure does not authorize the use of statistical sampling to substantiate meal and entertainment expenses as required by § 274(d).

(2) This revenue procedure does not authorize the use of statistical sampling to determine a taxpayer's liability for employment taxes or whether an amount is excludable from a taxpayer's income.

(3) This revenue procedure does not establish the correctness of a taxpayer's interpretation of § 274(n) or characterization of meal and entertainment expenses as expenses excepted from § 274(n)(1).

(4) This revenue procedure does not preclude the Internal Revenue Service from raising or pursuing any income, employment, or other tax issues identified in the review of a statistical sample.

## SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after May 3, 2004. However, with respect to the use of statistical sampling by a taxpayer for a taxable year ending before May 3, 2004, for which the applicable period of limitations has not expired, the Service will permit, but not require, application of this revenue procedure.

## SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1847.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in Appendix B. This information is required to ensure compliance with the statistical sampling methodology contained in this revenue procedure. The information will be used to evaluate compliance with the procedures described in this revenue procedure. The collection of information is mandatory. The likely recordkeepers are businesses or other for-profit institutions.

The estimated total annual recordkeeping burden is 3200 hours. The estimated annual burden per recordkeeper varies from six to ten hours, depending on individual circumstances, with an estimated average of eight hours. The estimated number of recordkeepers is 400.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## DRAFTING INFORMATION

The principal author of this revenue procedure is Kari L. Fisher of the Office of Associate Chief Counsel (Income Tax

and Accounting). For further information regarding this revenue procedure, contact Ms. Fisher at (202) 622-4970 (not a toll-free call). For further information regarding Appendices A, B and C, contact Ed Cohen of the Large and Mid-Size Business Division at (212) 719-6693 (not a toll-free call).

## APPENDIX A

### SAMPLING PLAN STANDARDS

The statistical sampling must be conducted in accordance with the following methodology.

1. Statistical (probability) sampling methodology may not include the use of judgment sampling.

2. Taxpayers may apply the results of a statistical sample only to the taxable years included in the sample.

3. A statistical sample may include data from no more than three consecutive taxable years.

4. Data from a taxable year may be included in only one statistical sample.

5. The estimated amount of expenses not subject to the § 274(n)(1) limitation must be based on a statistical (probability) sample, in which each sampling unit has a known (non-zero) chance of selection, using either a simple random sampling method or stratified random sampling method.

6. In general, the computation of the estimated amount of expenses not subject to the § 274(n)(1) limitation must be at the least advantageous 95% one-sided confidence limit. The “least advantageous” confidence limit is either the upper or lower limit that results in the least benefit to the taxpayer. However, if the precision of the change in the estimated deductible amount of expenses not subject to the § 274(n)(1) limitation (see paragraph 9 below) divided by the change in the estimated deductible amount of expenses not subject to the § 274(n)(1) limitation does not exceed 10%, the point estimate may be used in place of the least advantageous confidence limit. All strata for which “substantially all” of the population sampling units are sampled will be treated as 100% strata. That is, the overall point estimate and its precision will be estimated by treating all 100% strata appropriately for the sample design used. Also, the calcu-

lation of the denominator for the relative precision will exclude all 100% strata. For this revenue procedure, “substantially all” is defined as 80% or more.

7. Recognizing that many methods exist to estimate population values from the sample data, the Service will consider acceptable only the following estimators. Variable estimators permitted include the mean (also known as the direct projection method), difference (using “paired variables”), (combined) ratio (using a variable of interest and a “correlated” variable), and (combined) regression (using a variable of interest and a “correlated” variable). The first variable used for the difference, ratio and regression estimators must be the variable used in the mean estimator. The second variable used for the difference, ratio and regression estimators must be a variable that can be paired with the first variable and should be related to the first variable. For example, in a typical audit-sampling situation, the first variable would be the audited value of a transaction and the second variable would be the originally reported value of the same transaction. Since the latter two variable methods are statistically biased, there must be a demonstration that the bias is negligible before the Service will accept the method.

8. Variable sampling plans must use the qualifying final estimate with the smallest overall standard error as an absolute value (for example, the size of the estimate is irrelevant in the determination of the reported value).

9. Variable sampling plans must calculate confidence limits by addition and subtraction of the precision of the estimate from the point estimate in which the determination of precision proceeds by multiplication of the standard error by (i) the 95% one-sided confidence coefficient based on the Student’s *t*-distribution with the appropriate degrees of freedom, or (ii) 1.645 (the normal distribution), assuming the sample size is at least 100 in each non-100% stratum.

10. For either the (combined) ratio or regression methods, to demonstrate little statistical bias exists, the following applies after excluding all strata tested on 100% basis (the entire population of a stratum is selected for evaluation).

a. The total sample size of all strata must be at least 100 units.

b. Each stratum for a population estimate should contain at least 30 sample units.

c. The coefficient of variation of the paired variable must be 15% or less. The coefficient of variation of the paired variable (y) is defined as the standard error of the total “y” variables divided by point estimate of the total “y” variables when the “y” variables are commonly the reported values in accounting situations.

d. The coefficient of variation of the primary variable of interest, represented by either the corrected value or the difference between the reported and corrected values in common accounting situations, must be 15% or less. The coefficient of variation for the corrected value (x) is defined as the standard error of the total “x” variables divided by point estimate of the total “x” variables when the “x” variables are commonly the corrected values in accounting situations. The coefficient of variation for the difference (d) between the reported and corrected values (x-y) is defined as the smaller of the standard error of the total “x-y” or total “d” variables divided by the amount equaling total population value represented by “Y” plus point estimate of the total “x-y” or total “d” variables or the standard error of the total “x-y” or total “d” variables divided by the total “x-y” or total “d” variables when the “x-y” variables are commonly the difference (“d”) between the reported (“y”) and corrected (“x”) values in accounting situations.

e. For only the (combined) ratio method, the reported values of units must be of the same sign.

11. When sampling the same expense accounts for multiple taxable years, if a

single projection does not materially affect other computations that are more appropriately made on a yearly basis, it is permissible to combine the accounts into one population. There should be allocation of the combined result by a reasonable method determined prior to the selection of the sampling units.

12. A written sampling plan is required prior to the execution of a sample. A plan must include the following:

- a. The objective of the plan including a description of the value for estimation and the applicable taxable year(s);
- b. Population definition and reconciliation of the population to the tax return;
- c. Definition of the sampling frame;
- d. Definition of the sampling unit;
- e. Source of the random numbers, the starting point or seed, and the method of selection;
- f. Sample size, along with supporting factors in the determination;
- g. Method to associate random numbers to the frame;
- h. Steps to ensure that the serialization of the frame is independent of the drawing of random numbers;
- i. Steps for evaluating the sampling unit; and
- j. The estimator that was used for appraising the sample.

## APPENDIX B

### SAMPLING DOCUMENTATION STANDARDS

The taxpayer must retain adequate documentation to support the statistical application, sample unit findings, and all

aspects of the sample plan and execution. The execution of the sample must include information for each of the following items:

1. The seed or starting point of the random numbers;
2. The pairing of random numbers to the frame along with supporting information to retrace the process;
3. List of sampling units selected and the results of the evaluation of each unit;
4. Supporting documentation such as notes, invoices, purchase orders, project descriptions, etc., which support the conclusion reached about each sample item;
5. The calculation of the projected estimate(s) to the population, including computation of the standard error of the estimate(s);
6. A statement describing any slips or blemishes in the execution of the sampling procedure and any pertinent decision rules; and
7. Computation of all associated adjustments.

## APPENDIX C

### TECHNICAL FORMULAS

The formulas below are included to clarify the statistical sampling terms used and to ensure consistent application of the procedures described in the revenue procedure.

#### UNSTRATIFIED (SIMPLE RANDOM SAMPLE) MEAN ESTIMATOR

#### STRATIFIED MEAN ESTIMATOR

Sample Mean of Audited Amounts

$$\bar{x} = \frac{\sum x_j}{n}$$

Estimate of Total Audited Amount

$$\hat{X}_M = N \bar{x}$$

$$\hat{X}_{Ms} = \sum (N_i \bar{x}_i)$$

**UNSTRATIFIED (SIMPLE RANDOM SAMPLE)  
MEAN ESTIMATOR**

**STRATIFIED  
MEAN ESTIMATOR**

**Estimated Standard Deviation of the Audited Amount**

$$S_x = \sqrt{\frac{[\Sigma (x_j^2)] - n (\bar{x}^2)}{n - 1}}$$

**Estimated Standard Error of the Total Audited Amount**

$$\hat{\sigma} (\hat{X}_M) = \frac{N S_x \sqrt{1 - n/N}}{\sqrt{n}}$$

$$\hat{\sigma} (\hat{X}_{Ms}) = \sqrt{\Sigma \left[ N_i (N_i - n_i) \frac{S_{x_i}^2}{n_i} \right]}$$

**Achieved Precision of the Total Audited Amount**

$$A'_M = \frac{N U_R S_x \sqrt{1 - n/N}}{\sqrt{n}}$$

$$A'_{Ms} = U_R \sqrt{\Sigma \left[ N_i (N_i - n_i) \frac{S_{x_i}^2}{n_i} \right]}$$

**UNSTRATIFIED (SIMPLE RANDOM SAMPLE)  
DIFFERENCE ESTIMATOR**

**STRATIFIED  
DIFFERENCE ESTIMATOR**

**Estimate of Total Difference**

$$\hat{D} = N \bar{d}$$

$$\hat{D}_S = \Sigma (N_i \bar{d}_i)$$

**Estimate of Total Audited Amount**

$$\hat{X}_D = Y + \hat{D}$$

$$\hat{X}_{Ds} = Y + \hat{D}_s$$

**Estimated Standard Deviation of the Difference Amount**

$$S_D = \sqrt{\frac{[\Sigma (d_j^2)] - n (\bar{d}^2)}{n - 1}}$$

**Estimated Standard Error of the Difference Amount**

$$\hat{\sigma} (\hat{D}) = \frac{N S_D \sqrt{1 - n/N}}{\sqrt{n}}$$

$$\hat{\sigma} (\hat{D}_S) = \sqrt{\Sigma \left[ N_i (N_i - n_i) \frac{S_{D_i}^2}{n_i} \right]}$$

**Achieved Precision of the Difference Amount**

$$A'_D = \frac{N U_R S_D \sqrt{1 - n/N}}{\sqrt{n}}$$

$$A'_{Ds} = U_R \sqrt{\Sigma \left[ N_i (N_i - n_i) \frac{S_{D_i}^2}{n_i} \right]}$$



**UNSTRATIFIED (SIMPLE RANDOM SAMPLE)  
RATIO ESTIMATOR**

**STRATIFIED  
COMBINED RATIO ESTIMATOR**

**Estimated Ratio of Audited Amount to Recorded Amount**

$$R = \frac{\Sigma x_j}{\Sigma y_j} = 1 + \frac{\Sigma d_j}{\Sigma y_j}$$

$$\hat{R}_C = \frac{\Sigma (N_i \bar{x}_i)}{\Sigma (N_i \bar{y}_i)} = 1 + \frac{\Sigma (N_i \bar{d}_i)}{\Sigma (N_i \bar{y}_i)}$$

**Estimate of Total Audited Amount**

$$\hat{X}_R = Y \hat{R}$$

$$\hat{X}_{Rc} = Y \hat{R}_C$$

**Estimated Standard Deviation of the Ratio**

$$S_R = \sqrt{\frac{\Sigma (x_j^2) + \hat{R}^2 \Sigma (y_j^2) - 2\hat{R} \Sigma (x_j y_j)}{n - 1}}$$

**Estimated Standard Deviation of the Ratio in  $i^{\text{th}}$  Stratum**

$$S_{Rc_i} = \sqrt{\frac{\left[ \left( \Sigma x_{ij}^2 - (\Sigma x_{ij})^2 / n_i \right) \right] + \left[ \hat{R}_C^2 \left( \Sigma y_{ij}^2 - (\Sigma y_{ij})^2 / n_i \right) \right] - \left[ 2\hat{R}_C (\Sigma x_{ij} y_{ij} - n_i \bar{x}_i \bar{y}_i) \right]}{n_i - 1}}$$

**Estimated Standard Error of the Ratio Amounts**

$$\hat{\sigma} (\hat{X}_R) = \frac{N S_R \sqrt{1 - n/N}}{\sqrt{n}}$$

$$\hat{\sigma} (\hat{X}_{Rc}) = \sqrt{\Sigma \left[ N_i (N_i - n_i) \frac{S_{Rc_i}^2}{n_i} \right]}$$

**Achieved Precision of the Ratio Amounts**

$$A'_R = \frac{N U_R S_R \sqrt{1 - n/N}}{\sqrt{n}}$$

$$A'_{Rc} = U_R \sqrt{\Sigma \left[ N_i (N_i - n_i) \frac{S_{Rc_i}^2}{n_i} \right]}$$

**UNSTRATIFIED (SIMPLE RANDOM SAMPLE)  
REGRESSION ESTIMATOR**

**STRATIFIED  
COMBINED REGRESSION ESTIMATOR**

**Estimated Regression Coefficient**

$$b = \frac{[\Sigma (x_j y_j)] - n \bar{x} \bar{y}}{[\Sigma (y_j^2)] - n (\bar{y}^2)} = 1 + \frac{[\Sigma (d_j y_j)] - n \bar{d} \bar{y}}{[\Sigma (y_j^2)] - n (\bar{y}^2)}$$

$$b_c = \frac{\Sigma N_i (N_i - n_i) S_{XY_i} / n_i}{\Sigma N_i (N_i - n_i) S_{Y_i}^2 / n_i} = 1 + \frac{\Sigma N_i (N_i - n_i) S_{DY_i} / n_i}{\Sigma N_i (N_i - n_i) S_{Y_i}^2 / n_i}$$

**Estimate of Total Audited Amount**

$$\hat{X}_G = N \bar{x} + b (Y - N \bar{y})$$

$$\hat{X}_{Gc} = \Sigma (N_i \bar{x}_i) + b_c [Y - \Sigma (N_i \bar{y}_i)]$$

**Estimated Standard Deviation of the Regression Amounts**

$$S_G = \sqrt{\frac{1}{n-2} \left[ \sum (x_j^2) - n(\bar{x}^2) - \frac{(\sum (x_j y_j) - n\bar{x}\bar{y})^2}{\sum (y_j^2) - n(\bar{y}^2)} \right]}$$

**Estimated Covariance between the Audited and Recorded Amounts in  $i^{\text{th}}$  Stratum**

$$S_{XY_i} = \frac{[\sum (x_{ij} y_{ij})] - n_i \bar{x}_i \bar{y}_i}{n_i - 1}$$

**Estimated Standard Deviation between the Audited and Recorded Amounts in  $i^{\text{th}}$  Stratum**

$$S_{G_{C_i}} = \sqrt{S_{X_i}^2 - 2b_C S_{XY_i} + b_C^2 S_{Y_i}^2}$$

**Estimated Standard Error of the Audited and Recorded Amounts**

$$\hat{\sigma}(\hat{X}_G) = \frac{N S_G \sqrt{1 - n/N}}{\sqrt{n}}$$

$$\hat{\sigma}(\hat{X}_{G_c}) = \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{G_{C_i}}^2}{n_i} \right]}$$

**Achieved Precision of the Audited and Recorded Amounts**

$$A'_G = \frac{N U_R S_G \sqrt{1 - n/N}}{\sqrt{n}}$$

$$A'_{G_c} = U_R \sqrt{\sum \left[ N_i (N_i - n_i) \frac{S_{G_{C_i}}^2}{n_i} \right]}$$

**Definition of Symbols**

TERM	DEFINITION
n	Sample Size
N	Population Size
x	The value of the sampling unit that is being used as the primary variable of interest. In audit sampling, this would be the audited (or revised) value of the transaction.
y	The value of the sampling unit that is being used as the “paired” variable that is related to the variable of interest. In audit sampling, this would be the reported (or original) value of the transaction.
d	The value of the sampling unit that is the difference between “paired” variable (y) and the variable of interest (x). That is, d = x – y. In audit sampling, this would be the difference (or the change) of each transaction’s value.
X	The total value of the primary variable of interest. In audit sampling, this would be the estimated total audited value of the population. Typically, this value is not known for the entire population and is estimated based on the probability sample selected.

TERM	DEFINITION
Y	The total value of the variable that is paired with variable of interest. In audit sampling, this would be the total reported value of the population. Typically, this value is known for the entire population and may be estimated based on the probability sample selected.
D	The total value of the difference between the “paired” variable and the variable of interest. In audit sampling, this would be the estimated total difference of the population. Typically, this value is not known for the entire population and is estimated based on the probability sample selected.
$U_R$	The confidence coefficient which is based on either the Student’s <i>t</i> -distribution or the normal distribution. For example, a 95% one-sided confidence coefficient based on the normal distribution is 1.645. This term is often referred to as the <i>t</i> -value and the <i>z</i> -value.

# Part IV. Items of General Interest

## Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

### Partner's Distributive Share: Foreign Tax Expenditures

#### REG-139792-02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the proper allocation of partnership expenditures for foreign taxes. The proposed regulations affect partnerships and their partners. In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9121) that modify the rules relating to the proper allocation of creditable foreign taxes. The text of the temporary regulations also serves as the text of these proposed regulations. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by Tuesday, August 24, 2004. Outlines of topics to be discussed at the public hearing scheduled for Tuesday, September 14, 2004, at 10 a.m., must be received by Tuesday, August 24, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-139792-02), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-139792-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at [www.irs.gov/reg](http://www.irs.gov/reg) or [www.regulations.gov](http://www.regulations.gov). The public hearing

will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Beverly M. Katz, (202) 622-3050; concerning submissions and the hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

The temporary regulations amend the rules in 26 CFR part 1 regarding the allocation of foreign taxes among partners under section 704(b). The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the regulation.

##### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

##### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, September 14, 2004, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble. The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments by Tuesday, August 24, 2004, and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by Tuesday, August 24, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

##### Drafting Information

The principal author of this regulation is Beverly M. Katz, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in its development.

\* \* \* \* \*

##### Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

##### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.704-1 is amended as follows:

1. Paragraphs (b)(1)(ii)(b) and (b)(4)(xi) are added.

2. Paragraph (b)(5) is amended by adding *Example 25* through *Example 28*.

The additions and revisions read as follows.

*§1.704-1 Partner's distributive share.*

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(b) [The text of this proposed amendment is the same as the text of §1.704-1T(b)(1)(ii)(b) published elsewhere in this issue of the Bulletin].

\* \* \* \* \*

(4) \* \* \*

(xi) [The text of this proposed amendment is the same as the text of §1.704-1T(b)(4)(xi) published elsewhere in this issue of the Bulletin].

\* \* \* \* \*

(5) [The text of this proposed amendment of §1.704-1(b)(5) is the same as the text of §1.704-1T(b)(5) published elsewhere in this issue of the Bulletin].

John M. Dalrymple,  
*Acting Deputy Commissioner for  
Services and Enforcement.*

(Filed by the Office of the Federal Register on April 20, 2004, 8:45 a.m., and published in the issue of the Federal Register for April 21, 2004, 69 F.R. 21454)

## Notice of Proposed Rulemaking

### Determination of Basis of Stock or Securities Received In Exchange for, or With Respect to, Stock or Securities in Certain Transactions

#### REG-116564-03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 358 that provide guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions.

These proposed regulations affect shareholders of corporations.

DATES: Written or electronic comments must be received by July 2, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-116564-03), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 4 pm to: CC:PA:LPD:PR (REG-116564-03), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044, or sent electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-116564-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa Kolish, Emidio J. Forlini, Jr. or Reginald Mombrun, (202) 622-7930, concerning submissions of comments, Treena Garrett, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background and Explanation of Provisions

Section 1012 of the Internal Revenue Code (Code) provides that the basis of property is generally the cost of such property. Section 1.1012-1(c) provides that, if shares of stock are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred is charged against the earliest of such lots purchased or acquired in order to determine the basis of such stock.

Under this rule, a shareholder has greater flexibility in planning the tax consequences of the sale by specifically identifying the shares sold. The rules for adequate identification operate differently depending on the manner in which the shares are held and actions taken by the shareholder. For example, when shares are held through a broker, an adequate identification is effected by giving the

proper instructions to the broker. This rule allows identification without regard to the particular shares physically transferred by the broker. The rule also allows identification when several lots are represented by a single share certificate. However, if a shareholder holds a different share certificate for each lot, the identity of the shares is determined by the specific certificate sold.

Section 358(a)(1) generally provides that the basis of property received pursuant to an exchange to which section 351, 354, 355, 356, or 361 applies is the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer, the amount of any money received by the taxpayer, and the amount of loss to the taxpayer which was recognized on such exchange, and increased by the amount which was treated as a dividend, and the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend). Section 358(b)(1) provides that, under regulations prescribed by the Secretary, the basis determined under section 358(a)(1) must be allocated among the properties received in the exchange or distribution.

Section 1.358-2(a)(2) provides that, if as the result of an exchange or distribution under section 354, 355, 356, or former 371(b) a shareholder who owned stock of only one class before the transaction owns stock of two or more classes after the transaction, then the basis of all the stock held before the transaction (as adjusted under §1.358-1) must be allocated among the stock of all classes (whether or not received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class. In addition, §1.358-2(a)(3) provides that, if as the result of an exchange under section 354, 355, 356, or former 371(b) a security holder who owned only securities, all of one class, before the transaction, owns securities or stock of more than one class, or owns both stock and securities, then the basis of all the securities held before the transaction (as adjusted under §1.358-1) must be allocated among all the stock and securities (whether or not received in the transaction) held immediately after the transaction in proportion to

the fair market values of the stock of each class and the securities of each class.

Section 1.358-2(a)(4) provides that, in every case in which, before the transactions, a person owned stock of more than one class or securities of more than one class or owned both stock and securities, a determination must be made, upon the basis of all the facts, of the stock or securities received with respect to stock and securities of each class held (whether or not surrendered). The allocation described in §1.358-2(a)(2) is separately made as to the stock of each class with respect to which there is an exchange or distribution and the allocation described in §1.358-2(a)(3) is separately made with respect to the securities of each class, part or all of which are surrendered in the exchange.

Section 1.358-2(a)(5) provides a special rule that applies in cases in which a shareholder retains stock or securities pursuant to a plan of recapitalization under section 368(a)(1)(E). In those cases, the basis of the stock retained remains unchanged.

When all of the taxpayer's stock in a target corporation is transferred in a reorganization in exchange for stock of the acquiring corporation or the issuing corporation, it may be difficult to identify physically which share of stock of the target corporation was surrendered for which share of stock of the acquiring or issuing corporation. Questions have arisen regarding whether, for purposes of section 1012 and the regulations thereunder, a shareholder that sells or transfers shares of stock received in an exchange or distribution to which section 354, 355, or 356 applies can identify that share as being traceable to a particular lot of exchanged shares and, if so, how such an identification can be effected.

A number of authorities have addressed this issue but have reached inconsistent results. For example, in *Arrott v. Commissioner*, 136 F.2d 449 (3d Cir. 1943), the court reasoned that the shares surrendered in an acquisitive reorganization lost their identity when traded for new shares in the reorganization and held that the basis of the shares acquired was determined by averaging the basis of the shares exchanged. Accord *Commissioner v. Bolender*, 82 F.2d 591 (7th Cir. 1936); *Helvering v. Stifel*, 75 F.2d 583 (4th Cir. 1935); *Commissioner v. Von Gunten*, 76 F.2d 670 (6th Cir. 1935);

see also Revenue Ruling 55-355, 1955-1 C.B. 418.

On the other hand, other courts have rejected the average basis method for determining the basis of stock received in a reorganization. For example, in *Bloch v. Commissioner*, 148 F.2d 452 (9th Cir. 1945), the court permitted the basis of blocks of stock received in an acquisitive reorganization to be traced to the basis of the surrendered stock. The court reasoned that where the shareholder can trace the "transmigrations" of shares of stock, there is no reason the shareholder should not be entitled to identify which shares are sold. In *Kraus v. Commissioner*, 88 F.2d 616 (2d Cir. 1937), the court held that if a taxpayer acquires a corporation's stock at different times and at different prices and exchanges that stock in a recapitalization, the bases of that stock are not blended or averaged in computing the basis of the acquired stock. See also *Osrow v. Commissioner*, 49 T.C. 333 (1968).

The IRS and Treasury Department have considered whether tracing or averaging is the more appropriate method for determining the basis of stock received in a reorganization described in section 368 or a distribution to which section 355 applies. In view of the carryover basis rule of section 358, the IRS and Treasury are not convinced that a reorganization is an event that justifies averaging the bases of the exchanged blocks of stock. Moreover, the IRS and Treasury Department are concerned that averaging the bases of the exchanged blocks of stock may inappropriately limit the ability of taxpayers to arrange their affairs or may afford opportunities for the avoidance of certain provisions of the Code.

The authorities holding that the basis of shares received in a reorganization is determined by the average basis method have reached that conclusion on the basis that it is not possible to match shares received with shares surrendered. The IRS and Treasury Department do not believe that this inability requires the use of the average basis method. When stock of one corporation is surrendered in exchange for stock of another corporation in a reorganization, the documents governing the reorganization will typically identify how many, and what class of, shares of the target corporation are being exchanged for how many, and what class of, shares of the

acquiring or issuing corporation. That is, the exchanging shareholder will know that one or more shares of the acquiring or issuing corporation are being received in exchange for one or more shares of the target corporation. However, when the shareholder sells or transfers stock of the acquiring or issuing corporation, it may not know which share of stock of the target corporation corresponds to a particular share of the acquiring or issuing corporation. Although, in some cases, the exchange may present obstacles to physical tracing, these obstacles are not materially different from those that exist in the absence of a reorganization where shares are held through a broker or consolidated in a single certificate. Thus, the IRS and Treasury Department believe that it is appropriate to permit shareholders to identify the shares of the acquiring corporation sold or transferred by reference to the shares surrendered in exchange therefor.

These proposed regulations remove §1.358-2(a)(2) through (5) and (c) and replace these provisions with a more complete set of rules for determining the basis of each share or security received in a reorganization described in section 368 and a distribution to which section 355 applies. These proposed regulations generally provide that the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies will be the same as the basis of the share or shares of stock or security or securities exchanged therefor. The determination of which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security will be made in accordance with the terms of the exchange or distribution.

If more than one share of stock or security (or a combination of shares of stock and securities) is received in exchange for one share of stock or security, the basis of the share of stock or security surrendered will be allocated to the shares and/or securities received based on the fair market value of the shares and/or securities received. In addition, if one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities received in a manner that, to the greatest extent possible, reflects

that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price. Therefore, if a shareholder that acquired 2 shares of stock of a target corporation on Date 1 for \$2 each and 2 shares of stock of the target corporation on Date 2 for \$3 each and the shareholder exchanges such shares for 2 shares of the acquiring corporation, one share of the acquiring corporation will be treated as acquired for the shares of the target corporation acquired on Date 1 and the other share will be treated as acquired for the shares of the target corporation on Date 2. Accordingly, one share will have a basis of \$4 and the other share will have a basis of \$6. This rule avoids, to the greatest extent possible, creating shares or securities with split holding periods.

In the case of an exchange to which both section 351 and section 354 or section 356 applies, however, these rules do not apply if, in connection with the exchange, the shareholder or security holder also exchanges property for stock or securities in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder or security holder are assumed. This limitation on the application of these rules is intended to prevent a conflict between, on the one hand, those rules that apply to determine the basis of stock received in an exchange to which section 351 applies (including the effect of the application of section 357(c)) and, on the other hand, these proposed rules.

In the case of a distribution to which section 355 applies in connection with which there is no exchange of shares of stock or securities but only the receipt of additional shares of stock or securities, these proposed regulations provide that the basis of each share of stock or security of the distributing corporation is allocated between the share of stock or security of the distributing corporation and the share of stock or security received with respect to such share of stock or security of the distributing corporation in proportion to their fair market values. If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities received in a manner that re-

flects that, to the greatest extent possible, a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

The IRS and Treasury Department recognize that, in certain cases, the shareholder will not be able to identify which particular share (or portion of a share) of stock or security was exchanged for, or received with respect to, a particular share (or portion of a share) of stock or security. In these cases, the proposed regulations permit the shareholder or security holder to designate which share or security was received in exchange for, or in respect of, which share or security. Such designation, however, must be consistent with the terms of the exchange or distribution.

The designation must be made on or before the first date on which the basis of a share or security received is relevant, for example, the date on which a share or security received is sold or is transferred in an exchange described in section 351 or section 721 or a reorganization described in section 368. The designation is binding for purposes of determining the Federal tax consequences of subsequent transactions involving any share or security received or property received with respect to such share or security. If the shareholder fails to make a designation, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012-1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

The current regulations under section 358 include references to transactions described in former sections 371(b) and 374, which were repealed by section 11801(a)(19) of Public Law 101-508 (104 Stat. 1388) effective November 5, 1990. To reflect the repeal of these sections, these proposed regulations remove the references to sections 371(b) and 374 as they currently appear in the regulations under section 358.

#### **Effective Date**

These regulations are proposed to apply to exchanges and distributions of stock or securities occurring after the date these

regulations are published as final regulations in the **Federal Register**.

#### **Effect on Other Documents**

These proposed regulations would obsolete Revenue Ruling 55-355, 1955-1 C.B. 418, for transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

#### **Special Analysis**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov). The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

#### **Drafting Information**

The principal authors of these regulations are Reginald Mombrun, Theresa Kolish, and Emidio J. Forlini, Jr. of the Office of the Associate Chief Counsel

(Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

\* \* \* \* \*

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.358-2 also issued under 26 U.S.C. 358. \* \* \*

Par. 2. Section 1.358-1 is amended by:

1. Revising paragraph (a).
2. Adding paragraph (c).

The revision and addition read as follows:

#### *§1.358-1 Basis to distributees.*

(a) In the case of an exchange or distribution to which section 354 or 355 applies in which, under the law applicable to the year in which the exchange is made, only nonrecognition property is received, the sum of the basis of all of the stock and securities in the corporation whose stock and securities are exchanged or with respect to which the distribution is made, held immediately after the transaction, plus the basis of all stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation held immediately before the transaction allocated in the manner described in §1.358-2. In the case of an exchange to which section 351 or 361 applies in which, under the law applicable to the year in which the exchange was made, only nonrecognition property is received, the basis of all the stock and securities received in the exchange shall be the same as the basis of all property exchanged therefor. If in an exchange or distribution to which section 351, 356, or 361 applies both nonrecognition property and “other property” are received, the basis of all the property except “other property” held after the transaction shall be determined as described in the preceding two sentences decreased by

the sum of the money and the fair market value of the “other property” (as of the date of the transaction) and increased by the sum of the amount treated as a dividend (if any) and the amount of the gain recognized on the exchange, but the term gain as here used does not include any portion of the recognized gain that was treated as a dividend. In any case in which a taxpayer transfers property with respect to which loss is recognized, such loss shall be reflected in determining the basis of the property received in the exchange. The basis of the “other property” is its fair market value as of the date of the transaction. See §1.460-4(k)(3)(iv)(A) for rules relating to stock basis adjustments required where a contract accounted for using a long-term contract method of accounting is transferred in a transaction described in section 351 or a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met.

\* \* \* \* \*

(c) *Effective date.* Paragraph (a) of this section applies to exchanges or distributions of stock and securities after the date these regulations are published as final regulations in the **Federal Register**. Paragraph (b) of this section applies to exchanges or distributions of stock and securities after December 31, 1953.

Par. 3. Section 1.358-2 is amended by:

1. Revising paragraphs (a)(1) and (a)(2).
2. Removing paragraphs (a)(3), (a)(4), and (a)(5).
3. Revising paragraphs (b)(1) and (c).
4. Adding paragraph (d).

The revisions and addition read as follows:

#### *§1.358-2 Allocation of basis among nonrecognition property.*

(a) *Allocation of basis in exchanges or distributions to which section 354, 355, or 356 applies.* (1) As used in this paragraph, the term *stock* means stock which is not “other property” under section 356. The term *securities* means securities (including, where appropriate, fractional parts of securities) which are not “other property” under section 356.

(2)(i) If a shareholder or security holder surrenders a share of stock or a security

in an exchange under the terms of section 354, 355, or 356, the basis of each share of stock or security received in the exchange shall be the same as the basis of the allocable portion of the share or shares of stock or security or securities exchanged therefor (as adjusted under §1.358-1). If more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the share of stock or security surrendered shall be allocated to the shares of stock or securities received in the exchange in proportion to the fair market value of the shares of stock or securities received. If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

(ii) If a shareholder or security holder receives one or more shares of stock or one or more securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355) and does not surrender any shares of stock or securities in connection with the distribution, the basis of each share of stock or security of the distributing corporation (as defined in §1.355-1(b)), as adjusted under §1.358-1, shall be allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or security or securities (or allocable portions thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values. If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.



(iii) If a shareholder or security holder that purchased or acquired shares of stock or securities in a corporation on different dates or at different prices exchanges such shares of stock or securities under the terms of section 354, 355, or 356, or receives a distribution of shares of stock or securities under the terms of section 355, and the shareholder or security holder is not able to identify which particular share of stock or security (or portion of a share of stock or security) is received in exchange for, or with respect to, a particular share of stock or security, the shareholder or security holder may designate which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security, provided that such designation is consistent with the terms of the exchange or distribution. The designation must be made on or before the first date on which the basis of a share of stock or security received is relevant. The basis of the shares or securities received, for example, is relevant when such shares or securities are sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of, or distribution with respect to, the shares or securities received. If the shareholder fails to make a designation, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and § 1.1012-1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

(iv) Paragraphs (a)(2)(i) through (iii) of this section shall not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and section 354 or section 356, if, in connection with the exchange, the shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder or security holder are assumed.

(b) *Allocation of basis in exchanges to which section 351 or 361 applies.* (1) As used in this paragraph (b), the term *stock* refers only to stock which is not “other property” under section 351 or 361 and the term *securities* refers only to securities

which are not “other property” under section 351 or 361.

\* \* \* \*

(c) *Examples.* The application of paragraphs (a) and (b) of this section is illustrated by the following examples:

*Example 1.* (i) *Facts.* F, an individual, acquired 20 shares of Corporation N stock on Date 1 for \$3 each and 10 shares of Corporation N stock on Date 2 for \$6 each. On Date 3, Corporation O acquires the assets of Corporation N in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, F receives 2 shares of Corporation O stock for each share of Corporation N stock. Therefore, F receives 60 shares of Corporation O stock. Pursuant to section 354, F recognizes no gain or loss on the exchange. F is not able to identify which shares of Corporation O stock are received in exchange for each share of Corporation N stock.

(ii) *Analysis.* Under paragraph (a)(2) of this section, F has 40 shares of Corporation O each of which has a basis of \$1.50 and is treated as having been acquired on Date 1 and 20 shares of Corporation O each of which has a basis of \$3 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of Corporation O stock received becomes relevant, F may designate which of the shares of Corporation O have a basis of \$1.50 and which have a basis of \$3.

*Example 2.* (i) *Facts.* The facts are the same as in *Example 1*, except that instead of receiving 2 shares of Corporation O stock for each share of Corporation N stock, F receives 1½ shares of Corporation O stock for each share of Corporation N stock. Therefore, F receives 45 shares of Corporation O stock. Again, F is not able to identify which shares (or portions of shares) of Corporation O stock are received in exchange for each share of Corporation N stock.

(ii) *Analysis.* Under paragraph (a)(2) of this section, F has 30 shares of Corporation O each of which has a basis of \$2 and is treated as having been acquired on Date 1 and 15 shares of Corporation O each of which has a basis of \$4 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of Corporation O stock received becomes relevant, F may designate which of the shares of Corporation O have a basis of \$2 and which have a basis of \$4.

*Example 3.* (i) *Facts.* E, an individual, purchased 20 shares of Class A stock of Corporation P on Date 1 for \$3 per share and 10 shares of Class B stock of Corporation P on Date 2 for \$3 per share. On Date 3, E exchanges each share of Class A stock for one share of new Class C stock and one share of new Class D stock in a reorganization under section 368(a)(1)(E). Pursuant to section 354, E recognizes no gain or loss on the exchange. On the date of the exchange, the fair market value of each share of Class A stock is \$6, the fair market value of each share of Class C stock is \$2, and the fair market value of each share of Class D stock is \$4. E is not able to identify which shares of Class C and Class D stock of Corporation P are received in exchange for each share of Class A stock of Corporation P.

(ii) *Analysis.* Under paragraph (a)(2) of this section, because E receives one share of Class C stock and one share of Class D stock for each share of Class A stock, the basis of each share of Class A stock sur-

rendered is allocated to one share of Class C stock and one share of Class D stock in proportion to their fair market values. Therefore, \$1 of the basis of each share of Class A stock is allocated to each share of Class C stock and \$2 of the basis of each share of Class A stock is allocated to each share of Class D stock. E's basis in each share of Class B stock remains \$3.

*Example 4.* (i) *Facts.* G, an individual, purchased 10 shares of Corporation Q stock on Date 1 for \$2 per share and 10 shares of Corporation Q stock on Date 2 for \$5 per share. On Date 3, Corporation R acquires the stock of Corporation Q in a reorganization under section 368(a)(1)(B). Pursuant to the terms of the reorganization, G receives one share of Corporation R stock for every 2 shares of Corporation Q stock. Pursuant to section 354, G recognizes no gain or loss on the exchange. G is not able to identify which portion of each share of Corporation R stock is received in exchange for each share of Corporation Q stock.

(ii) *Analysis.* Under paragraph (a)(2) of this section, G has 5 shares of Corporation R each of which has a basis of \$4 and is treated as having been acquired on Date 1 and 5 shares of Corporation R each of which has a basis of \$10 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of Corporation R stock received becomes relevant, G may designate which of the shares of Corporation R have a basis of \$4 and which have a basis of \$10.

*Example 5.* (i) *Facts.* The facts are the same as in *Example 4*, except that, in addition to transferring the stock of Corporation Q to Corporation R, G transfers land to Corporation R. In addition, after the transaction, G owns stock of Corporation R satisfying the requirements of section 368(c). G's transfer of the Corporation Q stock to Corporation R is an exchange described in sections 351 and 354. G's transfer of land to Corporation R is an exchange described in section 351.

(ii) *Analysis.* Pursuant to paragraph (a)(2)(iv) of this section, because neither section 354 nor section 356 applies to the transfer of land to Corporation R, the rules of paragraphs (a)(2)(i) through (iii) of this section do not apply to determine G's basis in the Corporation R stock received in the transaction.

*Example 6.* (i) *Facts.* H, an individual, purchased 10 shares of Corporation T stock on Date 1 for \$3 per share and 10 shares of Corporation T stock on Date 2 for \$6 per share. On Date 3, Corporation V, a newly formed, wholly owned subsidiary of Corporation U, merges with and into Corporation T with Corporation T surviving. As part of the plan of merger, H receives one share of Corporation U stock for each share of Corporation T stock. In connection with the transaction, Corporation U assumes a liability of H. In addition, after the transaction, H owns stock of Corporation U satisfying the requirements of section 368(c). H's transfer of the Corporation T stock to Corporation U is an exchange described in sections 351 and 354.

(ii) *Analysis.* Pursuant to paragraph (a)(2)(iv) of this section, because, in connection with the transfer of the Corporation T stock to Corporation U, Corporation U assumed a liability of H, the rules of paragraphs (a)(2)(i) through (iii) of this section do not apply to determine H's basis in the Corporation U stock received in the transaction.

*Example 7. (i) Facts.* J, an individual, purchased 5 shares of Corporation X stock for \$4 per share on Date 1 and 5 shares of Corporation X stock for \$8 per share on Date 2. Corporation X owns all of the outstanding stock of Corporation Y. The fair market value of the stock of Corporation X, excluding the stock of Corporation Y, is \$900. The fair market value of the stock of Corporation Y is \$900. In a distribution to which section 355 applies, Corporation X distributes all of the stock of Corporation Y *pro rata* to its shareholders. No stock of Corporation X is surrendered in connection with the distribution. In the distribution, J receives 2 shares of Corporation Y stock with respect to each share of Corporation X stock. Pursuant to section 355, J recognizes no gain or loss on the receipt of the shares of Corporation Y stock. J is not able to identify which share of Corporation Y stock is received in respect of each share of Corporation X stock.

*(ii) Analysis.* Under paragraph (a)(2) of this section, because J receives 2 shares of Corporation Y stock with respect to each share of Corporation X stock, the basis of each share of Corporation X stock is allocated between such share of Corporation X stock and two shares of Corporation Y stock in proportion to the fair market value of those shares. Therefore, each of the 5 shares of Corporation X stock acquired on Date 1 will have a basis of \$2 and each of the 10 shares of Corporation Y stock received with respect to those shares will have a basis of \$1. In addition, each of the 5 shares of Corporation X stock acquired on Date 2 will have a basis of \$4 and each of the 10 shares of Corporation Y stock received with respect to those shares will have a basis of \$2. On or before the date on which the basis of a share of Corporation Y stock received becomes relevant, H may designate which of the shares of Corporation Y have a basis of \$1 and which have a basis of \$2.

*(d) Effective date.* This section applies to exchanges or distributions of stock and securities after the date these regulations are published as final regulations in the **Federal Register**.

Mark E. Matthews,  
*Deputy Commissioner for  
Services and Enforcement.*

(Filed by the Office of the Federal Register on April 20, 2004, 8:45 a.m., and published in the issue of the Federal Register for May 3, 2004, 69 F.R. 24107)

## Foundations Status of Certain Organizations

### Announcement 2004-36

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations

(Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

*Former Public Charities.* The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

1A Directors Champs Program, Inc.,  
Southlake, TX  
1st Lt. Alan Michael Hook Memorial Fund, Torrance, CA  
3rd Power Foundation, Copiague, NY  
1420 Foundation for Sustainable Development Education, Orlando, FL  
A. P. Hart Precious Moments Daycare, East Orange, NJ  
Access New York, Inc., Jamaica, NY  
Actors Summit, Akron, OH  
Adolescent Health Alliance, Inc., New York, NY  
African American Childrens Theatre, Ltd., Milwaukee, WI  
African American Health Initiative, Inc., Louisville, KY  
African American Males Making a Difference, Charlottesville, VA  
African Diaspora Music and Art, Inc., New York, NY  
Ahepa 371 II, Inc., Detroit, MI  
Airlie Gardens Foundation, Inc., Wilmington, NC  
Aiun Foundation for International Education and Democracy, Inc., Salem, OR  
Akron Newstead Youth Center, Inc., Akron, NY  
Al Horton Memorial Rotary Foundation, Desert Hot Springs, CA  
Allegheny West Business Education Foundation, Pittsburgh, PA  
Alliance Charitable Foundation, Inc., Amesbury, MA  
Alma Rangel Gardens Housing Development Fund Company, Inc., New York, NY  
Alpha House Project, Inc., Duluth, GA  
Alternative Community Living Services, Inc., Marietta, GA  
Alternative Medical Institute, Inc., Winsted, CT

Amani Christian Community Development Corp., Pittsburgh, PA  
America Alevit Cultural Center, Inc., Brooklyn, NY  
Amherst Domestic Violence Task Force, Inc., East Amherst, NY  
Anais Enterprises, Greensboro, NC  
Anshei Bnai Torah, Monsey, NY  
Arlington Golden Pride Band Booster, Riverside, CA  
Art Sanctuary, Philadelphia, PA  
Art Works Studio School, Incorporated, Washington, DC  
Atlanta Metropolitan Amateur Athletic Club, Atlanta, GA  
Atlantic Chamber Orchestra, Portland, ME  
Ats Foundation, Inc., Paoli, PA  
Azimuth Education Foundation, Lake Forest, CA  
Babylon Village Educational Foundation, Inc., Babylon, NY  
Baltimore County Small Business Resource Center, Inc., Towson, MD  
Banning Police Activities League, Inc., Banning, CA  
Barcare, Inc., Edison, NJ  
Beaver Girls Bantam Basketball Program, Beaver, PA  
Bedford Girls Basketball, Bedford, IN  
Beginning With Books, Pittsburgh, PA  
Believers Community Outreach, Los Angeles, CA  
Belleville Public Schools District 118 Educational Foundation, Ltd., Belleville, IL  
Bentley Hall Development Corporation, Inc., Philadelphia, PA  
Beth Chinuch Soro Bohel, Inc., Brooklyn, NY  
Black Geeks Online, Washington, DC  
Black Men for Progress, Farrell, PA  
Black Swamp Arts Council, Archbold, OH  
Blacksburg Volunteer Fire Department, Blacksburg, VA  
Bloomfield Amateur Boxing Association, Inc., Bloomfield, CT  
Bloomington Activities Foundation, Bloomington, MN  
Blue Ridge Education Fund, Inc., Roanoke, VA  
Blue Shift Theatre Ensemble, Boone, NC  
Blue Society of Center Pennsylvania, Shermans Dale, PA  
Bobby Telfer Memorial Scholarship Fund, Lansing, MI  
Books for Kids, Inc., Raleigh, NC  
Boyer Center for Education and Society, Grantham, PA

Brea Olinda Wildcat Softball Boosters,  
 Brea, CA  
 Brick City Soccer Club, Inc., Newark, NJ  
 Briercrest Family of Schools USA  
 Foundation, Point Roberts, WA  
 Buffalo Neighborhood Network, Inc.,  
 Buffalo, NY  
 Bulgaria America Cultural Exchange,  
 Inc., Larchmont, NY  
 California Condor Youth Wrestling,  
 Huntington, CA  
 California Conservatory of Music,  
 Menlo Park, CA  
 California Inland Region of Narcotics  
 Anonymous, Banning, CA  
 Cal-Lee Retirement Villa, Inc.,  
 Southern Pines, NC  
 Camden Urban Ministry Initiative, Inc.,  
 Camden, NJ  
 Camp Cathedral School of the Arts, Inc.,  
 Atlanta, GA  
 Capital Area Housing Resource Center,  
 Inc., Trenton, NJ  
 Care Consulting Services, Inc.,  
 Frederick, MD  
 Care Link Services, Lima, OH  
 Caring Citizens for Action, Inc.,  
 La Mesa, CA  
 Caritas of Yucaipa, Solana Beach, CA  
 Carolina Christian Education Foundation,  
 Fayetteville, NC  
 Carroll Elementary PTO, Inc.,  
 Shermans Dale, PA  
 Celebration Christian Life Community,  
 Ridgewood, NJ  
 Center for Natural Resources,  
 Stockton, MO  
 Center in the City, Scranton, PA  
 Central Park Towers, Inc., Kansas City, KS  
 Central School District Foundation,  
 Park Hills, MO  
 Century High School Model United  
 Nations Support Group, Santa Ana, CA  
 Charity Childrens Home at Ebenezer,  
 N. Wilkesboro, NC  
 Charleston Rotary Charitable Foundation,  
 Charleston, IL  
 Chatham Cultural Center, Inc.,  
 Chatham, MA  
 Cheltenham York Road Nursing  
 and Rehabilitation Center, Inc.,  
 Philadelphia, PA  
 Child & Family Profile, Inc., Chicago, IL  
 Child Assault Prevention of Ottawa  
 County, Port Clinton, OH  
 Childrens Dance Theatre of Ashland,  
 Ashland, OR  
 Christian Learning Centers of the Upstate,  
 Easley, SC  
 Christmas in April Topeka Shawnee Co.,  
 Inc., Topeka, KS  
 Christmas in April West End Cities,  
 Ontario, CA  
 Christs Mission, Marion, IL  
 City of Orange Public Library Foundation,  
 Orange, CA  
 Classical New Jersey Society, Inc.,  
 Plainfield, NJ  
 Clayton Rotary Foundation, Inc.,  
 Clayton, GA  
 Cleveland Center and Shelter,  
 Cleveland, OH  
 Cleveland Foot and Ankle Clinic,  
 Cleveland, OH  
 Cleveland Lumberjacks Charities, Inc.,  
 Cleveland, OH  
 Clover Commons, Inc., Rock Hill, SC  
 Coalition on Autism, Plains, PA  
 Colesville Lions Foundation, Inc.,  
 Silver Spring, MD  
 Colquitt Options, Albany, GA  
 Columbia South Rotary Foundation,  
 Columbia, MO  
 Commissioners Honor Camp Cadet, Inc.,  
 Hershey, PA  
 Communities in School of Maryland, Inc.,  
 Baltimore, MD  
 Communities in School of Prince Georges  
 County, Inc., Hyattsville, MD  
 Community Builders of Durham, Inc.,  
 Durham, NC  
 Community Connections, N. Platte, NE  
 Community Enforcement Authority, Inc.,  
 Atlanta, GA  
 Community Foundation of Mahoning  
 Valley, Youngstown, OH  
 Community Technology Development,  
 Inc., Newton, MA  
 Community Voices Collaborative  
 of the District of Columbia, Inc.,  
 Washington, DC  
 Compassionate Outreach Ministries  
 Christian Academy, Inc.,  
 Winter Park, FL  
 Connecticut Sports Institute Baseball  
 Association, Inc., Bridgeport, CT  
 Consumer Benefits Work America  
 Program, Mount Holly, NJ  
 Contextual Program Development  
 Foundation, Washington, DC  
 Cook County Intervention, Oak Lawn, IL  
 Costa Mesa Community Foundation,  
 Costa Mesa, CA  
 Coventry High School Gridiron Club,  
 Inc., Coventry, CT  
 Cross Connection Family Services,  
 Philadelphia, PA  
 Cross High Band Booster, Cross, SC  
 Dance Harrison Street, Inc., Easton, MD  
 Decalogue Education Fund, Inc.,  
 Chicago, IL  
 Depth Foundation, Inc., Northport, MI  
 Diakonia Media Group, Inc.,  
 Duxbury, MA  
 Dillsboro Tomorrow, Inc., Dillsboro, NC  
 Dimensions Dance Company,  
 St. Louis, MO  
 Disability Technologies, Inc.,  
 Hedgesville, WV  
 District Heights Community Development  
 Corporation, District Heights, MD  
 DI Blades, Detroit Lakes, MN  
 Doc Communications Media Group,  
 Somerset, NJ  
 Downingtown Community Center, Inc.,  
 Downingtown, PA  
 Downtown Senior Center, Inc.,  
 Scranton, PA  
 Downtown Yonkers Management  
 Association, Inc., Yonker, NY  
 Dressing to Succeed Licking County, Inc.,  
 Newark, OH  
 Duanesburg Education Foundation, Inc.,  
 Duanesburg, NY  
 Duneland Building Trades Corp.,  
 Chesterton, IN  
 Dunkard Creek Watershed Assn., Inc.,  
 Morgantown, WV  
 Durham Regional Financial Center,  
 Durham, NC  
 Dusty Wings of the Desert, Inc.,  
 Palm Desert, CA  
 Eagle Valley Senior Housing, Inc.,  
 Allentown, PA  
 East End Business & Merchants Council,  
 Bridgeport, CT  
 Eastfield Youth Activities, Nebo, NC  
 Eastside Community Economic  
 Development Corporation,  
 Charlotte, NC  
 Eaton Area Senior Center, Inc.,  
 Charlotte, MI  
 Eau Claire High School Foundation,  
 Chapin, SC  
 Education Express Company, Howell, NJ  
 Educational Foundation of Park Forest  
 Chicago Heights, Inc., Park Forest, IL  
 Educational Netcasting Foundation, Inc.,  
 Cambridge, MA  
 Ellwood City Education Foundation,  
 Ellwood City, PA  
 Elvie Neighborhood Community  
 Association, Inc., Wilson, NC

Emmanuel Bible Institute, New York, NY  
 Empire Theatre Co., Chicago, IL  
 Enrichment and Training Center,  
 Black Mountain, NC  
 E S P, Ltd., Dover, NH  
 Essex County Educational Foundation,  
 Inc., W. Orange, NJ  
 Essex Itv, Inc., Newark, NJ  
 Evangelical Catholic, Inc., Columbus, WI  
 Fair Housing for America, Riverside, CA  
 Fair Lawn Association for Special  
 Education, Fair Lawn, NJ  
 Fair Tide, Inc., Kittery, ME  
 Family Art Studio, Inc., St. Louis, MO  
 Family Depot, Inc., St. Louis, MO  
 Family First, Hamden, CT  
 Family Law and Policy Institute, Inc.,  
 Washington, DC  
 Family Life Home Christian School  
 Independent Study Program,  
 San Marcos, CA  
 Family Preservation Program, Inc.,  
 Warm Springs, VA  
 Family Support Network of Vance  
 Granville Franklin and Warren,  
 Oxford, NC  
 Family Support Systems, Pacifica, CA  
 Fauna Communications Research  
 Institute, Hillsborough, NC  
 Federacion De Organizaciones Mexicanas  
 En Nueva Inglaterra, Inc., Chelsea, MA  
 Federal Enterprise Community of Buffalo,  
 Inc., Buffalo, NY  
 First Flight, Inc., Sumter, SC  
 First Night Pittsburgh, Inc., Pittsburgh, PA  
 First Step Childcare & Preschool, Inc.,  
 Waterford Wks, NJ  
 Flights for Humanity, Incorporated,  
 Littleton, MA  
 Foundation for Charter Schools, Inc.,  
 Newark, NJ  
 Foundation for the Advancement of  
 Sexual Equity, Long Beach, CA  
 Foundation for United States Russian  
 Cultural Relations, Inc., Alexandria, VA  
 Foundations Reach Youth, Richmond, VA  
 F R A M E S, Flint, MI  
 Franco Foundation, Inc.,  
 Silver Spring, MD  
 Freedom Through Christ Ministry, Inc.,  
 Bloomington, IN  
 Freehold Borough Educational  
 Foundation, Inc., Freehold, NJ  
 Freehold Township Foundation for  
 Educational Excellence Incorporate,  
 Freehold, NJ  
 Friends of Cabot Woods, Inc.,  
 Newton, MA  
 Friends of Charlotte Advantage Charter  
 School, Inc., Charlotte, NC  
 Friends of Clinton Youth and Family  
 Service Bureau, Inc., Clinton, CT  
 Friends of College Wrestling, Inc.,  
 Grand Rapids, MI  
 Friends of Everett Arena, Concord, NH  
 Friends of Kalamazoo Advantage  
 Academy, Inc., Kalamazoo, MI  
 Friends of Mountain History, Inc.,  
 Asheville, NC  
 Friends of Octavio Paz Charter School,  
 Inc., Chicago, IL  
 Friends of Poway High Foundation,  
 Poway, CA  
 Friends of Rocky Mount Charter School,  
 Inc., Battleboro, NC  
 Friends of Seacoast Hospice,  
 Portsmouth, NH  
 Friends of the Public Library, Clive, IA  
 Friends of the School, Inc., Portland, IN  
 Friends of Wasatch Summit Counties  
 Childrens Justice Center, Park City, UT  
 Friends of Worc, Inc., Lake Success, NY  
 Friends of Wvon, Chicago, IL  
 Friends Who Care, Inc., New York, NY  
 Frontiers Journal, Inc., Rhinebeck, NY  
 Gary Wheaton Memorial Tri State  
 Respiratory Clinics, Vincennes, IN  
 Gateway Management Corporation,  
 Buffalo, NY  
 GEM Recreation & Health Center,  
 Kill Devil Hills, NC  
 Genesis Corporation, Thomasville, NC  
 Geoffrey Lance Foundation for Spinal  
 Cord Injury Res and Support,  
 Philadelphia, PA  
 Georgia Institute for Community  
 Development and Outreach, Inc.,  
 Atlanta, GA  
 Get the Message, Inc., Baltimore, MD  
 Ghana Computer Literacy & Distant  
 Education, Incorporated, Chicago, IL  
 Gilgal Development Corporation,  
 Plainfield, NJ  
 Global Childrens Health & Environment  
 Fund, Washington, DC  
 Global Education Foundation,  
 Alexandria, VA  
 Golden Dogs Academy, Inc.,  
 Mount Vernon, OH  
 Granite State Federation of Families, Inc.,  
 Manchester, NH  
 Great Expectations Weight Loss Camp,  
 Inc., Oakville, CT  
 Great Pond Foundation, Inc.,  
 Edgartown, MA  
 Greater Grand Forks Community Center  
 LLC, Grand Forks, ND  
 Greater Hope Life Center, Inc.,  
 New York, NY  
 Greater Options for Adolescent Lives,  
 Inc., Boston, MA  
 Greater Philadelphia Cancer Foundation,  
 Philadelphia, PA  
 Greater Southern Brooklyn Health  
 Coalition, Inc., Brooklyn, NY  
 Greenville Chinese School,  
 Greenville, NC  
 Greenwich Agora, Inc., Greenwich, CT  
 Grosse Pointe South Choir Boosters, Inc.,  
 Grosse Pointe Farms, MI  
 Hall-Light and Associates, Hampton, VA  
 Hamilton County Self Help Housing,  
 Webster City, IA  
 Hampden County Land Trust, Inc.,  
 Monson, MA  
 Hand Craft Alliance, Waynesboro, VA  
 Hands & Minds, Inc., Cambridge, MA  
 Hands on Helpers, Inc., Princeton, NJ  
 Happy Times Development Corporation,  
 Inc., Philadelphia, PA  
 Harlem Renaissance Economic  
 Development Corporation,  
 New York, NY  
 Hartford Teen Center,  
 White River Junction, VT  
 Hawaii Ola Waimanalo, Honolulu, HI  
 Hawkeye East Wrestling Club, Inc.,  
 Christiansburg, VA  
 Health, Incorporated, Sioux City, IA  
 Heart and Soul Ministries, Inc.,  
 Altoona, PA  
 Heartland Opera Theatre, Webb City, MO  
 Hellas United Fc, Inc., Boston, MA  
 Henry White Experimental Farm  
 Foundation, Belleville, IL  
 Heritage Band Boosters, Monroeville, IN  
 Herminia M. Roque Memorial Social  
 Service Center, Chicago, IL  
 High Tech High Foundation,  
 San Diego, CA  
 Hillel of Rockland County, Inc.,  
 Monsey, NY  
 Hillside Business Association,  
 Duluth, MN  
 Hinsdale South High School Foundation,  
 Darien, IL  
 Hiram Foundation, Incorporated,  
 Long Beach, CA  
 Hispanic National Law Enforcement  
 Association New York Chapter  
 Foundation, New York, NY  
 Historical Advancement Association,  
 Philadelphia, PA

Hoffman Estates Park District Foundation,  
 Hoffman Estates, IL  
 Holy Care, Inc., Lanham, MD  
 Holy Cross Neighborhood Development,  
 Inc., Pittsburgh, PA  
 Home of Hope Learning and Resource  
 Center, Inc., Hinesville, GA  
 Homegrown, Inc., Brockton, MA  
 Hope & Help, Inc., Brooklyn, NY  
 Hope and New Dreams of Adelphi, Inc.,  
 Adelphi, MD  
 H O P E Initiatives, Inc., Heralding  
 Opportunities Potentials Education,  
 Macon, GA  
 Housing Opportunities Made Economical,  
 Inc., Fredericksburg, VA  
 Human Family Foundation,  
 Annandale, VA  
 Humanist Ministries, Inc., Milwaukee, WI  
 Hunter College High School  
 Chinese Parents Association, Inc.,  
 New York, NY  
 Huntsville Bible Students, Huntsville, AL  
 I Vote Project, Inc., Wilmington, DE  
 Ice Dogs Hockey Club,  
 Dearborn Heights, MI  
 Independence Empowerment Center, Inc.,  
 Manassas, VA  
 Independent Tech Alumni Council, Inc.,  
 Boston, MA  
 Indo-Pacific Conservation Alliance,  
 Washington, DC  
 Infinites Chamber Ensemble, Inc.,  
 Kensington, NH  
 Innerchange Freedom Initiative,  
 Washington, DC  
 Intelliport Corporation, Chillicothe, OH  
 International Centre for Eyecare  
 Education Foundation,  
 So. San Francisco, CA  
 International Concerned Friends  
 and Family of Mumia Abu Jamal,  
 Philadelphia, PA  
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 Interscholastic Athletic Association of  
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 Ivan Pravirov Dainius Zubrus Hockey  
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 Jones College Scholarship Fund,  
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 Kemper Military School and Endowment,  
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 Kings Highway, Inc., Mt. Holly, NJ  
 Kuntu Repertory Theatre, Pittsburgh, PA  
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 KVMH Charitable Foundation, Inc.,  
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 Laguna Hills High School Friends  
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 Atlanta, GA  
 Lapidra Family Firefighters Memorial  
 Fund, Staten Island, NY  
 Leadership Akron, Akron, OH  
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 Inc., West Lebanon, NH  
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 Incorporated, Libertyville, IL  
 Library Foundation of Madison County,  
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 Life Long Learning Group, Matthews, NC  
 Lincoln Park Elementary School PTO,  
 Lincoln Park, NJ  
 Liverpool High School Student Activities,  
 Liverpool, NY  
 Living Letters Ministries, Inc.,  
 St. Louis, MO  
 Love Is, Incorporated, Ontario, CA  
 Loving Hands, Inc., South Bend, IN  
 Low Country Artists and Artisans Society,  
 Savannah, GA  
 Lutheran Social Services of Central Ohio  
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 Mahwah Ramapo Ridge Home and  
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 Make It Happen Foundation, Inc.,  
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 Mars Hill Media, Minneapolis, MN  
 Marthas Vineyard Touchdown Club,  
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 Massachusetts Mental Health Counselors  
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 Merrimack Valley Regional Animal  
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 Museum of the Americas Foundation,  
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 National Institute for Prostate &  
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 National Organization for Children, Inc.,  
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If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as pro-

vided in section 1.509(a)-7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.



# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

## Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.

ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.

PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2003–27 through 2003–52 is in Internal Revenue Bulletin 2003–52, dated December 29, 2003.

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<sup>1</sup> A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2003–27 through 2003–52 is in Internal Revenue Bulletin 2003–52, dated December 29, 2003.

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